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Board Members:

This letter represents my views on the proposed auditing standards dealing with the auditor's report: PCAOB Release No. 2013-005 dated August 13, 2013. I previously commented on the concepts release on this same matter through my letter dated July 21, 2011. My comments are derived primarily from perspectives gained from serving as chairman of the audit committee for five large public companies over the past twelve years.

The views that follow address a number of the provisions in the exposure draft and include both support for and recommendations related to certain provisions. However, there are two proposals that I believe should be eliminated from any final standard:

- The required disclosure of critical audit matters (CAM), and
- The required disclosure of the tenure of the audit firm

Further, while I expressed support in my earlier letter for inclusion in the report of limited auditor assurance on "other information," I have major reservations about

how that matter has been treated in the exposure draft and do not support the current position.

My reasoning for these beliefs is presented later in this letter. Before getting to that, I would like to express my agreement with and appreciation for the Board's decision not to move forward with the major changes suggested in the concepts release of (1) an auditor's discussion and analysis or (2) required and expanded emphasis paragraphs. For reasons noted in my earlier letter, I did not support those changes as was true for most other commentators. I did support limited improvements to the auditor's report that are included in the exposure draft:

Clarifying that the auditor is required to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

Addressing the auditor's report to both shareholders and the board of directors.

Additionally:

In my earlier letter I indicated that I was ambivalent about having the auditor's report refer to the related footnotes as well as the basic financial statements and I can certainly support it as part of the current exposure draft.

In my earlier letter I indicated that the title of the report (Report of Independent Registered Public Accounting Firm) seemed sufficient and there appeared to be no reason to require a statement in the body of the report that the audit firm is independent. However, this is a minor matter and I have no serious objection to the proposed inclusion of the language.

The remainder of this letter provides my comments on what I consider the major matters in the proposal.

The Pass/Fail Model

While the auditor's report has undergone certain revisions during my half century in the profession, the essential pass/fail model has stood the test of time and been retained. The proposal continues that model and the release notes that many commentators support it "... because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented. Additionally,

commenters indicated support for the concise and useful message of the pass/fail model.” I strongly agree with those sentiments.

However, I am concerned that the inclusion of several pages of critical audit matters as would be the case under the Board’s proposal would make it more difficult for readers of the auditor’s report to even locate the opinion on the financial statements and internal controls. This could be addressed in a number of ways should the Board retain the critical audit matters requirement. For example, the Board could require that the key opinion language be stated at the very outset of the report. It could be required to be presented in bold type or a subheading could be required, as the proposal suggests for the CAM section. At the extreme, the Board could require that all reports include a footnote on the first page calling attention to where the opinion can be found (e.g., “See page 11 for our opinion on the accompanying financial statements and internal control over financial reporting”).

You may think I’m being a bit facetious in making these suggestions but I’m really not. I sincerely believe that most users of auditor’s reports are mainly interested in whether the financial statements are fairly presented (a clean opinion), and they will look for guidance to work around lengthy auditor reports that contain information that they are not interested in. Journalists and others will provide that guidance to that vast majority of the public who simply want to find in the report whether the company has “passed.” But if the PCAOB retains the critical audit matters requirement, it could make things a lot easier for users by adopting one of the ideas I just mentioned.

However, my strong preference is that the Board omits the CAM requirement from a final rule for a number of reasons mentioned in the following section.

Critical Audit Matters

As defined, critical audit matters are “Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.” “Most difficult” is a common theme although the proposal also makes clear that “most” doesn’t limit disclosure to a single item in a category.

The language of the proposal indicates that the Board expects multiple CAMs in most cases. “Under the proposed auditor reporting standard, it is expected that, in most audits, the auditor would determine that there are critical audit matters (page A5-27).” “The proposal anticipates that in most audits the auditor would determine that there are critical audit matters and, depending on the circumstances of an audit, there may be several critical audit matters (Statement of Board Member Jeanette M. Franzel).” Further, I believe auditors would be highly motivated to err on the side of including more rather than fewer CAMs in their reports, else the PCAOB inspections staff will second guess their judgments after the fact. In the words of Board Member Lewis H. Ferguson, “It provides a standard that audit firms, regulators like the PCAOB, and others to measure compliance with the requirements of the standard.” (His earlier comments supported the Board’s approach because it allows auditors “substantial latitude to exercise professional judgment in determining what items to include as CAMs but constrains that judgment by an objective standard, the reasonable and experienced auditor looking at the same evidence.”) Different auditors (or different inspectors, in the case of the PCAOB) will clearly reach different judgments so why would an auditor be motivated to determine that a particular matter is not a CAM when it is a close call?

In addition to the definition of CAMs as noted above, the proposal notes that “Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document, (2) reviewed by the engagement quality reviewer, (3) communicated to the audit committee, or (4) any combination of the three.” Further, the proposal’s documentation requirements include “non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters.”

The matters presently included in MD&A disclosures (see further discussion below) would almost certainly be judged as CAMs and most of them would probably fall under category (3). However, based on my experience in the auditing profession, I believe there will be many more matters included in categories (1) and (2) above and thus required to be considered as possible CAMs under the proposal. Given the need to document that matters in these categories are not CAMs, in too many cases auditors will be motivated to judge that they should be included in their reports to avoid a later challenge from the PCAOB inspections staff. Materiality considerations, of course, will come into play. But this is another issue where judgment is required and the motivation may well be to disclose more to avoid second guessing.

In a worst case scenario, auditors could even be motivated to not include matters in the engagement completion document or not communicate them to the audit committee in order to avoid the possibility of having them judged, after the fact by a PCAOB inspector, as a CAM. The PCAOB should be very careful about such possible unintended consequences that could decrease audit quality while intending to enhance communication.

I commend the Board for requesting examples of what auditors think they would include as CAMs under current circumstances. Having some realistic examples to ponder as the Board goes through its redeliberations should be very instructive. And it's equally important that the Board involve users in this exercise. Once you have a number of "real world" examples of what auditors would include in their reports, then it should be imperative to test how users would react to those disclosures and see if they would actually find them to be beneficial. The Board should be able to demonstrate some practical benefits to investors and creditors of adding these voluminous disclosures to the auditor's report before the fact rather than requiring all auditors and companies to incur substantial costs on the basis that they "might" be useful.

Board member Jay D. Hanson said it best in his remarks at the public meeting at which the proposal was adopted. "I would particularly like to encourage auditors to work with their client's audit committees and management to perform some voluntary mini 'field tests,' where the engagement partner, the engagement quality reviewer, management and the audit committee each independently consider what issues may constitute critical audit matters under the proposed standard. Perhaps even share them with investors to obtain their views on the usefulness of the information." I full agree with Mr. Hanson except for the "perhaps" language. For such field tests to be meaningful, they must include the reactions of the users of the auditor's report.

I have recently completed a number of years of service on large public company boards and reached the mandatory retirement age. So I'm not able to participate directly in a field test similar to that suggested by Mr. Hanson above. However, based on my experience and publicly available information, I can provide my own assumptions about what would be included in the CAMs for my two most recent board assignments, Legg Mason and Fannie Mae. Legg Mason is a Fortune 1000 asset management company and Fannie Mae is one of the largest financial services companies, guaranteeing home loans for a substantial percentage of the U.S.

For Legg Mason, the section of the most recent 10-K that reports on “Critical Accounting Policies and Estimates” includes six matters:

Consolidation (variable interest entities)

Revenue recognition

Valuation of financial instruments

Intangible assets and goodwill

Stock based compensation

Income taxes (recovery of deferred tax asset)

I think it’s fair to assume that all of these would be strong candidates for consideration as CAMs by Legg Mason’s auditors. And, without getting into confidential matters, it’s possible that there would be others, particularly given the exposure draft’s push for auditors to reach judgments on the side of disclosing more rather than less.

As noted, all of these matters are already disclosed – extensively – by the company in MD&A – as well as further in the footnotes to the financial statements. It’s not clear to me what users will gain by further mention of them in the auditor’s report other than perhaps confusion about the auditor’s assessment thereof, as mentioned below. Depending on whether the auditor elects to include a description of the audit procedures applied, I would estimate that including the matters above as CAMs in the auditor’s report for Legg Mason would add somewhere between 3-6 pages to that report.

For Fannie Mae, the section in MD&A on Critical Accounting Policies and Estimates includes only four matters:

Fair value measurement

Total loss reserves

Other-than-temporary impairment of investment securities

Deferred tax assets

However, that section is six pages long (in quite small type!) and makes reference to the financial statement footnotes as well. For a company as large and complex as Fannie Mae, it's probably reasonable to assume that the auditors would have additional judgment matters to consider as possible CAMs, although their materiality would have to be assessed. As noted, I'm concerned that the PCAOB's application of this kind of standard will be a sort of "gotcha" exercise through the inspection program so that for large, complex companies like Fannie Mae, there would be a number of potential CAMs for which the audit firm would err on the side of inclusion.

Page A5-36 of the proposal notes that, "... the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so." In reading the actual proposed standard, I found it curious that there is no mention of this – the proposal is simply silent on the matter. Having read the background section first, I had expected to find some wording (perhaps at least a footnote) that would state the Board's position on this matter. Then I found it doubly curious that the three Illustrative Examples of CAMs provided by the Board on pages A5-65-78 all included illustrative language of auditing procedures performed to deal with the CAM in question. This would seem to indicate an implicit preference for inclusion of such language in spite of the wording in the background section and in spite of not dealing with the matter in the basic standard.

Of more concern than the lack of clarity on this matter, the inclusion of audit procedures language may cause readers to infer that auditors are expressing reservations in their reports about the matters in question. That is because there is no opinion stated after the audit procedures language. I'm sure the PCAOB believes that the overall opinion on the financial statements is all that is needed. And it's certainly not appropriate under current standards for an auditor to add a separate opinion in its report on each of these individual matters. But by including them in the report and then listing audit procedures for each without a conclusion, the reader may well infer a form of qualification ("subject to") for each. An easy fix would be for a final standard to simply prohibit the inclusion of discussion of audit procedures. However, I believe this is just another reason why the inclusion of CAMs in the auditor's report is a bad idea and should be dropped.

Another concern relates to the current-year only requirement. While I appreciate the Board's effort to take a cost-sensitive approach, given that the report covers three years of financial reports, inclusion of CAMs for only the current year is apt

to be confusing rather than helpful in at least some cases. Expecting users to review prior year filings in order to analyze CAMs over time seems to defeat the purpose of an auditor's report comprehensively reporting on the financial statements being included in the package currently delivered to those users.

Similar to my comments about the notion about an AD&A in the Concepts Release, I believe that including CAMs in auditor's reports would likely lead to an administrative nightmare in trying to wrap up the audit given that each report would be custom made and would likely have to be cleared with a firm's national office accounting and auditing technical experts and perhaps even legal staff. Further, given that the CAMs would include matters that the company is also reporting in most cases, such as significant accounting estimates, those matters would require extensive discussion and negotiation with company finance and legal staff at a time when meeting SEC deadlines is quite challenging. Rather than spending time on procedures that really add value to the audit, audit partners would find themselves haggling over wording issues that could serve as an unnecessary distraction. This factor alone should persuade the PCAOB not to advance the notion of CAMs as Board members should already know that too much partner time is involved in pinning down minor details of financial statement footnotes and other matters that take away from involvement in more important audit tasks.

As one final matter concerning CAMs, as the Board notes on pages A5-42-3 of the proposal, in certain cases (e.g., significant deficiencies in internal controls, certain going concern considerations), the auditor would be required to disclose information in the report that would not otherwise be required to be disclosed by management. This reverses the normal relationships of management and auditor and should be avoided.

In summary with respect to CAMs, I believe that adding multiple pages to the auditor's report of what would usually be duplicative of information reported elsewhere in the MD&A or financial statement footnotes would be of questionable value to the users of financial statements and may even obscure the principal purpose of highlighting an overall opinion on those statements. Further, I have provided certain other reasons that make such CAMs problematic and should cause the Board to conclude that such a fundamental change to the auditor's report is not justified at this time.

Reporting on "Other Information"

As noted earlier, in my comment letter on the concepts release I supported “limited auditor assurance” on other information outside of the audited financial statements. By that I meant that I believed the standard auditor’s report would be enhanced by incorporating the substance of AU 550 so as to inform investors and other readers of the report of the extent of the auditor’s responsibility for the other information in 10-K’s, etc. The auditor presently reports this to the audit committee and I believed this was one matter that could be added to the external report that would aid communications with investors with little or no change in procedures.

Thus, I would have supported an exposure draft position that adopted a reporting requirement based on procedures that auditors are already performing. In my earlier comment letter I noted that reading the non-financial statement information and considering whether it is materially consistent with the audited financial statements seems sufficient to me.

At first reading, a proposed requirement to “read and evaluate” rather than “read and consider” doesn’t sound like too substantive a difference. However, after reading summaries of the proposal issued by certain of the major accounting firms, I’m concerned that the change in wording will be more than a semantic one. For example, my former firm, Ernst & Young, reported that, “The proposal would require the auditor to perform additional procedures and to evaluate this information based on relevant audit evidence obtained and conclusions reached during the audit.” Further, EY’s analysis indicated that, “We believe additional audit effort and cost would be required to comply with the proposal.” Likewise, Deloitte stated, “The proposal’s auditor performance provisions significantly add to the auditor’s responsibilities for other information by introducing required audit procedures to support the auditor’s conclusion about the auditor’s evaluation of other information. Specifically, under AU Section 550, the auditor is required to “**read**” and “**consider**” other information, whereas under the proposal, the auditor is required to “**read**” and “**evaluate**” the other information on the basis of relevant audit evidence obtained and conclusion reached during the audit.”

As I have thought about this more, I am concerned not only that auditors will require more work to be done in order to meet the new standard, but the readers of the reports may assume a great degree of accountability that is warranted. For example, the subheading specified in the sample report in the proposal is “The Auditor’s Responsibilities Regarding Other Information.” The following wording notes that the “evaluation” of such “responsibilities” was based on “relevant audit evidence obtained and conclusions reached during the audit.” A reader could reasonably infer from that wording that procedures were specifically designed and

added to the audit work performed in order to support the “evaluation” so reached. This sounds like incremental audit testing work rather than the negative assurance from already performed auditing procedures that actually underlies this paragraph of the opinion. While that paragraph appropriately ends with a disclaimer of opinion on the other information, users may well read more into the overall message than intended.

This is another aspect of the proposal that calls for a form of field testing. The Board should work with accounting firms to determine what procedures they believe they would have to perform in order to meet the requirements of the exposure draft. This should be done with enough accounting different firms and with enough different sample clients within those firms to form a representative basis of what such a new requirement would actually entail. Neither the PCAOB nor the accounting profession should want a repeat of the situation that occurred after the issuance of PCAOB Auditing Standard 2 on internal control that had to be substantially modified when it was found that auditors performed far more work than intended by the Board.

In summary, I do not support this part of the proposal as written. The Board should reconsider the possibility of incorporating the substance of AU550 with a reporting requirement in the auditor’s report. If that is not considered feasible, I believe this part of the proposal should be dropped.

Auditor Tenure

A major, new addition to the auditor’s report would be, “A statement containing the year the auditor began serving consecutively as the company’s auditor.” The background information on this matter in Appendix 5 indicates that academic research is mixed as to whether short- or long-term audit relationships are more likely to adversely affect audit quality. Nevertheless, the Board indicates that “... investors and other financial statement users have indicated strong interest in this information.” A footnote reference to a Council of Institutional Investors’ policy statement is used to support this assertion.

Comments by individual Board members are somewhat less effusive in their support. For example, Lewis H. Ferguson stated, “Is this tenure information relevant or useful to financial statement users? Opinion varies on that question, but providing it in the audit report should not, in my view, involve additional cost either to the auditor or the issuer, and some financial statement users may find that information to be of interest.”

Board member Jeanette M. Franzel expressed much doubt about this aspect of the proposal: "...the Board has not found evidence that would allow generalized conclusions about the impact of auditor tenure on audit quality." And, "I am concerned that by including auditor tenure in the auditor's report, there may be an implication that there is an analytical basis for interpreting such information."

Further, Board member Jay D. Hanson made comments similar to those of Ms. Franzel, "I question whether it is appropriate for the Board to require disclosure in the audit report of the auditor's tenure with the particular client." And, "Thus, we do not have, at this point, any data indicating that audit tenure has any correlation with audit quality."

Taken together, the very brief comments in the Board's basis for conclusions along with the statements of the individual Board members would seem to indicate a view that (1) some users have asked for this information, (2) we've looked at a lot of research and haven't found a persuasive basis for saying whether audit longevity affects audit quality one way or the other, (3) it wouldn't hurt (or cost) anything to add this to the standard auditor's report, (4) so let's put this in the exposure draft and see what reaction we get. This sounds like a classic case of running something up the flag pole to see what people think, even when there isn't much conviction among those charged to decide the issues.

Disclosure of auditor tenure is an issue that was actually faced on one of my former corporate board assignments – Legg Mason. However, there it was in the context of disclosure in the proxy statement of information about the relationship with our external auditor for purposes of the shareholder vote on ratification of the Audit Committee selection of the auditors for the coming year. After some discussion with an interested shareholder, the company decided to provide more information, including the year in which the current audit relationship had begun, about the Audit Committee's selection of the independent auditor, oversight thereof, engagement partner rotation, etc.

Audit firm tenure information may be useful when asking shareholders to vote on an Audit Committee action, in order to give them a full understanding of the situation. However, in an auditor's report a simple statement of when the audit relationship began won't have any context and, thus, will be of limited or no value to nearly all users. Thus, I do not support this aspect of the proposal and believe it should be eliminated. Rather, it should be left to the discretion of companies in providing appropriate information in proxy statements. Or, at some point the SEC

may wish to consider further required disclosures about audit relationships in proxy statements.

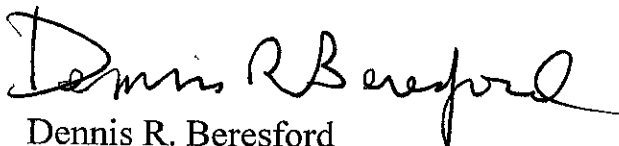
Other Changes in the Description of an Audit

Paragraph 6m of the exposure draft specifies that the standard auditor's report would include a statement that an audit covers certain matters concerning audit procedures performed in assessing possible material misstatements, amounts and disclosures in the financial statements, and evaluation of accounting principles and significant estimates made. An illustration of the suggested wording for the new disclosures that would result from the part of this section of the proposal that is incrementally different from the present standard is in Appendix A of the exposure draft. While I don't believe that such changes will make a profound difference in users' understanding of the work of independent auditors, the proposals appear to be straight forward and they may be of marginal value in helping describe the nature of an audit.

Conclusion

As noted in my earlier letter on the Concepts Release, I believe some improvements to the current form of the auditor's report can be made. However, including critical audit matters would be a serious mistake for many reasons noted above. I also have reservations about the positions on "other information" and auditor tenure as noted. I trust you will give appropriate consideration to my comments and would be pleased to elaborate on them as you request.

Sincerely,



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