August 1, 2016

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

Via email to comments@pcaobus.org

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the PCAOB Rulemaking Docket Matter No. 034; PCAOB Release No. 2016-003: Proposed Auditing Standard -- The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section – American Accounting Association

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Responses to Selected Questions in the Reproposal

Question 1a. *Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?*

We generally agree that requiring auditors to consider, for critical audit matter (CAM) treatment, all matters communicated or required to be communicated to the audit committee is appropriate, subject to the materiality requirement discussed in the reproposal. We believe that the requirements for auditor communication to the audit committee in PCAOB Auditing Standard No.16 (reorganized as AS 1301) align neatly with the intentions of the reproposal. We also believe that the reproposal requirement will help achieve a more uniform approach for auditors' consideration of which matters merit CAM treatment and provide a more orderly platform against which auditors, including quality review auditors, can perform and document their CAM-related procedures and decisions.

We do however acknowledge concerns raised by many respondents to the original proposal that the CAM reporting requirement may "chill" communications between management, auditors, and audit committees. Two recent studies provide insight into this issue. In one study, Gay and Ng (2015) find that auditors who face a more "reactive" audit committee are less likely to communicate with the audit committee about an uncertain accounting estimate in the presence of a CAM reporting requirement than when no such requirement exists. This effect is not observed with a more proactive audit committee, suggesting that the rigor of an audit committee's oversight of the external audit will be key to addressing this concern. In another study, Cade and Hodge (2014) find that managers exhibit less "communication openness" toward their auditors in the presence of a CAM reporting requirement. Participants acting in the role of management were less likely to share private information about a key accounting estimate with auditors if the auditors were required to report on the key estimate. Each of these studies suggest that CAM reporting requirements risk less candid communication regarding key matters of uncertainty in the financial statements. Such a risk could be exacerbated by requiring auditors to consider all matters communicated to the audit committee for treatment as CAMs.

Question 4. *Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a re-audit? Why or why not?*

We generally believe that the critical audit matter reporting requirements should extend to *all* financial reporting periods covered by the audit report, and should apply to all audits. While this "all periods" approach undoubtedly leads to increased length of the audit report, we think it is important for three primary reasons. First, the audit report itself usually covers multiple periods and we believe it should stand on its own in a manner similar to the financial statements and disclosures. Next, excluding critical audit matters related to prior periods increases the burden on users of information search. Prior research (Loibl and Hira 2009) suggests that investors with higher search costs (e.g., unsophisticated investors) decrease their information search relative to investors with lower search costs (e.g., financial analysts). We note that the Board highlights the burden of information search in other sections (e.g., audit tenure) of the reproposal and we appreciate this concern and believe it also applies in this

context. Finally, prior year CAMs (e.g., uncertain reserve estimates), by construction, would frequently have multiple year implications.

Question 6. *Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:*

a. *The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit.*

We know of one recent study that might provide some insight on this concern. Fuller (2016) studies whether management disclosure decisions are impacted by the level of detailed discussion an auditor provides for a critical audit matter involving an uncertain accounting estimate (no CAM, brief CAM, or detailed CAM) and the vigor of audit committee oversight. Fuller (2016) found that when audit committee oversight was strong, auditors providing more detailed discussion of a CAM led to enhanced management disclosure of the uncertain accounting estimate including important *quantitative* information about the estimate such as the range and sensitivity analysis of the estimate. The study was done before the reproposal requirement that the auditor specifically discuss the audit procedures employed to address the CAM was added, which would merit further research.

Rather than two independent binary choices (disclose/not disclose) made by the auditor and management, we believe it is much more likely that disclosure of specific information regarding a CAM will be guided by an iterative "negotiation" between auditor and client management similar to how proposed audit adjustments are resolved (Fuller 2016). As many voices in the debate over CAMs have mentioned, the requirement of the auditor to report on CAMs is likely to give leverage to the auditor in seeking out necessary disclosure by management. Such a scenario would reduce the likelihood that the auditor would be the original source of information. Rather, the auditor will be including information within its CAM discussion that will likely overlap with greater management disclosure.

b. *Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?*

The literature speaks to two possible misinterpretations of the audit report: (1) CAM-related content causing users to confuse a CAM statement with an audit qualification and (2) users failing to ascribe the same level of assurance and auditor responsibility to CAM areas as other areas of the audit. Each is discussed in turn.

With respect to the first possibility, Brasel, Doxey, Grenier, and Reffett (2016) provide some direct evidence regarding unsophisticated users' interpretations of CAMs. Brasel et al. conducted an online experiment using U.S. citizens eligible for jury duty as subjects. The participant pool is, therefore, likely in the lower tail of financial sophistication, and thus, most likely to misinterpret aspects of the auditor's report. Despite this low level of financial sophistication, the results of manipulation checks included in Brasel et al. suggest such basic misinterpretation is unlikely. After reading an auditor's report with the CAM language proposed in PCAOB Release 2013-005, and a specific CAM paragraph similar to those in

the current proposal (including the reasons the item was considered a CAM, the procedures applied, and the results of the procedures) participants were asked two true/false questions to assess their understanding of the unqualified audit report; 1) "[the auditor] issued an unqualified (clean) opinion for [the company]," and 2) "[the auditor] believes that [the company's] financial statements are materially misstated." Respondents answered these two questions correctly at a rate of 97.9 percent and 93.5 percent, respectively, indicating a low rate of misinterpretation caused by CAMs. It appears that this sample of unsophisticated users still largely understood the basic nature of the unqualified audit report and that the auditors were not indicating the presence of a misstatement. Consistent with these findings, Kachelmeier, Schmidt, and Valentine (2015) report that participants reviewing a CAM audit report expressed the same confidence in the financial statements "in general" as participants reviewing a control (current regime) report.

Five recent studies speak to the second possibility. These studies largely examine CAM disclosures in a legal liability setting and cases involving litigation over misstatements, so are reviewed in detail when we respond to questions 10 and 12, not here.[1] Though we provide the implication of those studies for the current question 6b here.[2]

In order to reduce the risk that users would misconstrue CAM paragraphs as modifying the audit report or that users would ascribe differing levels of assurance to CAM discussions and the remainder of the audit report, we propose modest changes to the Board's illustration of the Unqualified Report on pgs. A-17 to A-18 of the reproposal. Our suggested modifications are highlighted in blue in the draft auditor report in our Exhibit 1 below, the last two pages of our response.

> First, to provide a stronger linkage between the *Opinion Paragraph* and the discussion of CAMs, we suggest the following words be included at the end of the Opinion Paragraph:
>
> > "We are providing under "Critical Audit Matters" below, information on certain matters we communicated to the Audit Committee, which in no way alters our opinion on the financial statements taken as a whole. We do not provide separate opinions on the critical audit matters, or on the accounts or disclosures to which they relate."

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[1] A sixth study by Christensen, Glover, and Wolfe (2014) also examines investor reactions to modifications to the auditor's report. However, we do not include the results in the main text because the study was conducted prior to the Board's 2013-005 release and uses a "CAM" approach and wording substantially different from those subsequently proposed and reproposed by the Board. To summarize, Christensen et al. found that including a paragraph in the auditor's report regarding difficult audit areas resulted in an increased likelihood that participants would "stop considering the firm as an investment" (2014, 72), but the effect was eliminated with the addition of a paragraph explaining the resolution of the matter (the procedures applied by the auditor) and specific assurance over the audit area.

[2] The studies reviewed in our response to questions 10 and 12 suggest CAM disclosure may act as partial disclaimers or public forewarnings of increased misstatement risk in a majority of settings, decreasing auditor liability (Brasel et al. 2016; Brown, Majors, and Peecher 2015; Kachelmeier et al. 2015). Whereas two studies suggest there might be settings in which CAM disclosure increases auditor responsibility / liability (Backof, Bowlin, and Goodson 2014; Gimbar, Hansen, and Ozlanski 2016b).

Second, the following similar language (as shown in Appendix – B illustration of the Unqualified Report on pgs. A-17 to A-18) would be removed from the *CAM section*:

> "Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate."

The introduction to the CAM section would then only contain the definition.

Question 7. *In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?*

We believe that it would not be appropriate for the auditor to reference other information outside of the audited financial statements for two main reasons. First, the audit report conveys the auditor's opinion on the financial statements, and, accordingly, all references to information in their report should be contained in the financial statements under audit. Second, referencing information not contained in the financial statements could confuse readers. Research has long shown (c.f. Libby 1979) that users of financial statements have a difficult time distinguishing between various levels of auditor association with information, and referencing unaudited information in the audit report would only serve to exacerbate their misperceptions. Report readers would need to accurately determine the reliability of the referenced information, and may ascribe a higher (or lower) level of reliability, or auditor level of assurance to the information. For example, if information in Management's Discussion and Analysis (MD&A) is referenced in the audit report, readers may readily assume that the MD&A has been audited, when it has not been. Thus, referring to disclosures outside the financial statements risks readers being confused as to the level of association the auditor has with the referenced information.

Question 8. *Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?*

We are aware of one study that directly addresses the explicit "No CAM" condition.[3] Brasel et al. (2016) manipulated CAM paragraphs such that participants either saw a CAM that matched the litigated misstatement, a CAM that did not match the litigated misstatement, a control (no mention of CAMs), or a "No CAM" statement in which CAMs were defined, but the auditors explicitly stated that they did not identify any CAMs. All conditions were run with two misstatement types (a liability and an asset). The "No CAM" condition exhibited the highest levels of auditor liability, significantly higher than the matched CAM conditions, marginally higher than the mismatched CAM conditions, and not statistically different than the control condition. This result suggests stating that there are no CAMs potentially increases auditor liability.

[3] The CAM research summary by Gimbar et al. (2016a) identifies the Kachelmeier et al. study as having a "No CAM" condition. However, a careful review of the most recent (December 2015) version of the paper available on SSRN found no such condition mentioned.

<u>Question 9.</u> *Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?*

We agree with the Board that the newly limited scope for CAM inclusion to only relate to amounts or disclosures that are material to the financial statements should make CAM identification and documentation requirements easier to comply with. As a practical expedient, some members of our committee believe the reproposed documentation requirement should include only items that the auditor considered for CAM inclusion be subject to the documentation requirement, even among those items communicated to the audit committee. Admittedly this may be a distinction without a difference if firms feel it is necessary to consider every item communicated to the audit committee for inclusion as a CAM. The reasoning is as follows: while prior academic research *suggests* that documenting issues considered, but ultimately rejected as CAMs could increase auditor liability in those areas (see Reffett 2010 and Backof 2015), failure to document why an area is or is not a CAM could be even more problematic. It would be a daunting task for the firms to protect themselves from second-guessing during Board inspections, internal quality control reviews, and litigation if there is no documentation of the auditor's conclusion as to why a "likely suspect" area considered for inclusion was *not* identified as a CAM. Tautologically, any given audit area/issue *not* identified as a CAM either was not considered for CAM inclusion, in which case, we believe it should not be covered by the documentation requirement. Or if it is considered for CAM inclusion and rejected, the auditor should have some justification for that conclusion. Assuming that an item was considered for CAM inclusion and rejected, this would seem to be an important audit judgment that ought to be documented for review by the engagement and quality control review partners.

Other members believe that another possible way to address the CAMs documentation requirement would be to limit §17a to matters that are required to be communicated to the audit committee (as in AS No. 16, reorganized as AS 1301), and exclude matters that were communicated to the audit committee, but were not required communications. For example, if an audit committee member of a manufacturing company, in a meeting with their auditors, asks a question regarding the reasonableness of the entity's depreciation calculation and related estimates, the documentation requirement in the reproposal would require auditors to document why the accounts and amounts related to depreciation expense and accumulated depreciation are not CAMs. More broadly, requiring auditors to filter though all issues discussed in audit committee meetings to determine whether the issues relate to accounts or disclosures that are material to the financial statements, in order to document that they did not involve especially challenging, subjective or complex auditor judgement would create unintended additional documentation. Limiting documentation of potential CAMS to items required to be communicated to audit committees would also be consistent with the discussion in the reproposal that suggests auditors "…could start with the communications to the audit committee, which are already documented, identify which matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether each matter involved especially challenging, subjective, or complex auditor judgment" (p. 39).

Question 10. *What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?*

and

Question 12. *Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?*

To date, the preponderance of evidence suggests that disclosure of a CAM may effectively act as a disclaimer (Kachelmeier et al. 2015) or a public forewarning (Brasel et al. 2016) and may reduce auditor liability for a misstatement, subject to the caveat that the CAM matches the misstated area. Brown, Majors, and Peecher (2015) also find that CAMs related to a misstatement reduce judgments of auditor negligence in litigation over the misstatement. These three studies taken together provide evidence that CAMs matching subsequently discovered misstatement areas reduce auditor legal liability. It is also important to note that these findings are robust to theory (each study employs a unique theory), participant pool (jury eligible individuals, law students, attorneys, financial analysts and MBA students), case facts, and the financial statement area of the CAM. However, the apparent liability reduction is somewhat sensitive to the comparison group in each study. For instance, in Brasel et al. (2016) the liability reduction was significant for matching CAMs compared to a control (current reporting regime) and compared to an explicit statement that there were no CAMs. However, there was no difference in legal liability compared to the case in which the CAM did not match the subsequently misstated area. This pattern of findings is similar to those of Kachelmeier et al. (2015).

The effect of CAMs on legal liability may also depend on the nature of the financial statement area associated with the CAM. Brasel et al. (2016) point out that the reduction in auditor liability occurred for a financial statement area (inventory) where the participants believed the plaintiff was less likely to expect financial reporting difficulties absent a CAM. Liability was not reduced when the CAM matched a financial statement area where participants believed users should already have a higher expectation of financial reporting difficulties (an estimated environmental restoration liability).

The findings of two additional papers appear to conflict with the findings of Brasel et al., Brown et al., and Kachelmeier et al. (2015). Specifically, Gimbar, Hansen, and Ozlanski (2016b) find that, relative to the current audit report, CAMs do not affect auditor liability under imprecise accounting standards, while both related and unrelated CAMs increase auditor liability under precise (bright-line) standards. Backof, Bowlin, and Goodson (2014) find that CAMs increase auditor liability only when audit procedures are included in the report (including audit procedures is also a feature in Brasel et al. (2016), where the opposite conclusion is reached), but that this effect is nullified when the meaning of reasonable assurance is also clarified. Thus, a simple, but potentially useful takeaway from the Backof et al. (2014) findings is that clarifying reasonable assurance in the auditor's report could potentially combat any increases in auditor liability associated with CAMs. Also, as noted by Kachelmeier et al., in both the Backof et al. (2014) and Gimbar et al. (2016b) studies, auditor liability was increased in cases where there was a violation of correct GAAP accounting (an inappropriate inventory valuation method and incorrect lease classification, respectively)

indicating that the auditors accepted a GAAP violation in the accounting method. Thus, matching CAMs may only reduce auditor liability in "gray" areas of accounting, or as in the Brasel et al. (2016) study, in cases of management fraud in which the auditor did not know the accounting was incorrect.

Kachelmeier et al. (2015) go beyond jury decision making for auditor liability (proxied by MBA students) and also examine the effects of CAMs on the confidence MBA students, attorneys (plaintiff and defense perspectives), and financial analysts express in the financial statement areas associated with the CAM prior to any information about subsequent misstatements. They find that all groups expressed significantly lower confidence in the specific financial statement values associated with a CAM compared to values not associated with CAMs. Defense-perspective attorneys and MBA students also expressed lower confidence in CAM financial statement values compared to a control (current-practice) report. However, as previously noted, none of the groups expressed lower confidence in the financial statements "*in general*" (Kachelmeier et al. 2015, 3). Kachelmeier et al. (2015) conclude that CAM disclosures act as a partial disclaimer and that their findings are consistent with a piecemeal opinion. A more detailed and nuanced discussion of the results of all five of these studies can be found in the individual papers and in a summary by Gimbar et al. (2016a).

Question 13. *Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?*

The answer to the question, *"Is the reproposed requirement relating to auditor independence clear?"* is yes. However, the answer to *"whether or not this information improves investors' and other financial statement users' understanding of the auditor's independence responsibilities"* is more complicated. Considering that neither the PCAOB nor the SEC regulations provide a definition for auditor independence nor adequately discuss the inter-relationships between independence, objectivity and integrity, and conflicts of interest, this assumption lacks a strong foundation. Taylor, DeZoort, Munn and Wetterhall-Thomas (2003) state that definitional inconsistencies, or the use of varied and inconsistent definitions and conceptualizations, is a major source of confusion and controversy surrounding auditor independence. In 2008, the Advisory Committee on the Accounting Profession (ACAP) report to the U.S. Department of Treasury noted potential misunderstanding, at least with requirements about independence, among audit stakeholders and encouraged "improved understanding of … auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors to enhance investor confidence in the quality of the audit process and audits (ACAP 2008)."

Perhaps a more productive means of improving all parties understanding of auditor independence would be to clarify within the standards themselves the meaning and role of auditor independence to protect the virtues of integrity, objectivity and professional skepticism in situations involving conflicts of interest. Rather than defining the terms of objectivity, integrity or independence, Interpretations under Rule 102.02 provide a list for

determining misrepresentations in the preparation of financial statements or records[4]. Gramling, Jenkins, and Taylor (2010) suggest independence rules such as these meet at least two public policy goals. First, is to protect "independence in fact" by attempting to reduce the influence of incentives provided by external factors that could undermine auditor objectivity and inappropriately influence auditor judgments and decisions. Second, is to maintain "independence in appearance" by promoting auditor reliability and audit quality to inspire investors' confidence in the audit opinion. We question whether the direction taken by the PCAOB to rely on proscriptions of relationships rather than providing guidance through definitions and frameworks demonstrating the interrelationship of these important concepts will sufficiently promote the intended benefits of an independence requirement. How realistic is the expectation that the independent auditor will *achieve a proper degree of independence* in the conduct of his work by administering his practice within the spirit of these *precepts* and *rules*?

In conclusion, while we believe that the reproposed requirement relating to auditor independence is clearly stated, we suggest that merely requiring the inclusion of the auditor independence requirement in the audit report does not provide the necessary information to improve investors' and other financial statement users' understanding of the auditor's independence responsibilities. We suggest that as standard setters, the PCAOB needs to incorporate within its standards clear definitions and a more specific discussion of interrelated concepts of independence, integrity, objectivity and conflicts of interests. This action will more appropriately provide the necessary information to improve investors' and other financial statement users' understanding of the auditor's independence responsibilities.

Question 16. *Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information in the auditor's report which the Board should consider? If so, what are they?*

The Committee does not believe that the case for requiring audit firm tenure information has been adequately made or supported in the reproposal. We largely agree with the sentiments of Board Members Franzel (2016) and Hanson (2016) that there is no clear documented link between auditor tenure and multiple measures of audit and financial reporting quality. For example, research on the association between audit firm tenure and audit reporting accuracy (Geiger and Raghunandan 2002), fraudulent financial reporting (Carcello and Nagy 2004), financial reporting quality (Johnson, Khurana, and Reynolds 2002) and meeting analyst expectations (Davis, Soo, and Trompeter 2009) either find no association or find that the early years of auditor tenure are more problematic for audit quality in the U.S. Yet, as noted by Franzel (2016), the mere inclusion of this data in the auditor's report presumes that there is some sort of overriding relationship between audit firm tenure and audit quality.

Further, as noted by Lennox (2014) in his review of this literature, if there is a relationship between audit firm tenure and audit quality, we do not even have a good grasp of the direction

[4] Both the SEC and the PCAOB sets of standards provide a generally consistent number of requirements and proscriptions related to the auditor's financial, business and employment relationships, the provision of non-audit services, contingent fees, partner rotation, and audit committee responsibilities around independence focused on financial and relationship-based independence.

of causality. That is, we do not know if longer audit firm tenure leads to higher audit and financial reporting quality, or if higher audit and financial reporting quality leads to longer audit firm tenure. Accordingly, supplying this information in the audit report may be data, but it is data that is very difficult for users of the auditor's report to interpret, and the implication is that longer tenure equates to lower audit quality.

In addition, in support of this disclosure, the reproposal mentions that the European Union (EU) includes information on audit firm tenure in their new audit report. However, the EU has recently instituted mandatory audit firm rotation rules which make information on audit firm tenure of more direct interest to report readers of EU companies. The U.S. does not have such a rule, eliminating the need for report readers in the U.S. to be concerned with monitoring audit firm tenure in order to determine when the company will be required to change audit firms.

Question 18. *Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?*

While there is no extant research directly addressing this question, we believe that auditor tenure information is something that some investors may want, but that inclusion in the auditor's report is inappropriate. Providing the auditor tenure on Form AP would be a reasonable alternative solution. Information on the length of audit firm tenure is consistent with the intended provision of Form AP to increase the transparency and accountability for key participants in issuer audits and is consistent with the type of information on the current audit required on Form AP. In addition, inclusion of this information on Form AP would appear more of a "fact" than an implication of an association with audit quality. Alternatively, auditor tenure information could be included in the proxy statement in regards to shareholders' approval of the audit committee's selection of the independent auditor.

The reproposal states: "*The intent of the reproposed requirement, consistent with the 2013 proposal, is to require consistent reporting of the duration of the auditor's relationship with the company and have this information in a consistent location—the auditor's report (p. 48).*" We believe this is best accomplished by requiring disclose of auditor tenure on Form AP (or in the appropriate section of the company's proxy statement). Accordingly, we modified the draft auditors report eliminating the sentence "~~We have served as the Company's auditor since [year]~~"in our Exhibit 1 below, the last page of our response.

Question 19. *Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?*

For those investors interested in such information, certainly inclusion on the face of the auditor's report would reduce search costs. However, most investors interested in this data likely already have access to data aggregators (e.g., Thomson Reuters, *FirstData*, *Audit Analytics*, etc.) that will include this as part of their database whether in the auditor's report, on Form AP, or in the appropriate section of the proxy statement.

If the Board votes to require this information in the auditor's report, requiring disclosure in a specific location would be beneficial both in terms of practitioner implementation of the requirement, as well as investors locating the information.

Question 20. *Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or Why not?*

We believe that the audit report should positively state the concept that an audit is intended to provide reasonable assurance that the financial statements are free of material misstatements whether due to error or fraud. Such communication is likely to (i) motivate auditors to effectively plan and execute the audit to achieve this purpose, and (ii) enable investors to use the information communicated by the audited financial statements without seeking too much additional information for making decisions.

A field experimental study by Gist, Shastri, Ward, and Wilson (2005) manipulated the audit report wording (using three versions of auditor's report formats) and examined 122 auditors (partners and managers) and 123 financial statement users (financial analysts and bank lending officers) and found that incorporating 'fraud wording' both in the scope (auditor's responsibility) and opinion paragraphs significantly enhanced the users' evaluation of the audit report compared to the audit report without the 'fraud wording.' Accordingly, we believe the opinion paragraph should incorporate "free of fraud" related wordings[5]. More specifically, in addition to stating that the "…financial statements are free of material misstatements due to error or fraud…" in the *Basis for Opinion* paragraph, we suggest that the *Opinion* paragraph incorporate fraud-related wordings, as follows: "In our opinion, the financial statements *are free of material misstatements due to error or fraud, and* present fairly, in all material respects … Our suggested modification is highlighted in blue in the draft auditor report in our Exhibit 1 below, the last page of our response.

Question 22. *Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?*

We agree with the reproposal requirement that inclusion of CAMs within explanatory paragraphs located elsewhere in the audit opinion should not serve as a *substitute* for their inclusion in the new *Critical Audit Matters* section of the report or vice versa for several reasons. First, allowing for such a substitution could lead to great diversity in practice and possible confusion of users as to where the discussion of CAMs and explanatory paragraph topics are located within each opinion.

Second, it is possible that if CAMs are distributed across multiple sections of the report, users might unconsciously assign to various CAMs differential importance not intended by the auditor. Kahneman and Frederick (2002) find that when people perform difficult judgment tasks (e.g., evaluating the importance of CAMs to the financial statements), they sometimes

[5] See Gist, Shastri, Ward and Wilson. (2005) regarding the effectiveness of the Auditing Standards Board in improving audit communication with the SAS 58 auditor's standard report.

resort to using heuristic cues as a substitution for the more effortful processing necessary for the judgment. Inclusion of a matter in a less prominent location in the report (e.g., within an explanatory paragraph) as opposed to including it within a prominently labeled *Critical Audit Matters* section of the report could provide such a cue leading the user to find the matter less important.

Finally, we believe that distribution of CAMs across multiple sections of the report unnecessarily increases the cost of information search to users. We agree with the Board's proposal allowing for cross-referencing of CAMs between the *Critical Audit Matters* section of the report and explanatory paragraphs elsewhere so long as each CAM is identified in the *Critical Audit Matters* section of the report and each explanatory paragraph required is included in the proper location within the report.

Question 27. *How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?*

and

Question 29. *Would critical audit matters be useful in assessing company financial performance? If so, how?*

Essentially, these two questions are directed toward identifying the benefits investors and other audit report users would hope to gain from disclosure of CAMs. We believe that investors will derive the following benefits from CAMs reporting:

1. A better understanding of the range of possible outcomes for the amounts and disclosures presenting the greatest uncertainty in the financial statements.[6]
2. A better sense of the overall quality of the company's financial reporting.
3. More informed models of a firm's current performance and future prospects.
4. Lower cost of information acquisition by the leveraging the auditor's clearer communication in the audit report.

Some recent research has addressed these issues. Sirois et al. (2015) find that investors do key in on CAMs and acquire information related to the CAMs elsewhere in the financial disclosures more efficiently. However, they also identify some negative aspects of reporting CAMs in that investors tend to neglect non-CAM issues in the financial statements. Further, Christensen et al. (2014) find that nonprofessional investors are more influenced by a CAM paragraph than when the identical information is provided by management in the financial disclosures. As discussed further in response to Question 35 below, a study by Elliott, Fanning, and Peecher (2016) addresses the information needs of investors and finds that investors will use CAMs as intended sources of additional information from the auditor regarding uncertainty surrounding specific financial statement amounts and disclosures. Elliott et al (2016) also find that a well-crafted CAM discussion can decrease "extraction costs" for investors seeking information on financial reporting quality.

[6] This has been a common theme among investor stakeholders in much of the five years of debate.

The results reported in Foster and Shastri (2013) suggest that disclosure under CAM of non-trivial yet immaterial misstatements that affect income/earnings could none-the-less provide useful information to investors. As noted by the former SEC Chairman, Mr. Arthur Levitt, "missing an earnings projection by as little as a penny can result in a loss of millions of dollars in market capitalization (Levitt 1998)."

<u>Question 31.</u> *Would the communication of critical audit matters enhance attention by auditors, audit committees and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?*

One recent study provides evidence regarding the impact of CAM reporting on management disclosure behavior. Specifically, Fuller (2016) investigates how managers respond when auditors bring heightened attention to a critical accounting estimate in their CAM reporting. The study also investigates the influence of the audit committee on managers' disclosure behavior using an experiment with public company CFO participants.

Results suggest that managers are more likely to expand their accounting estimate disclosures when auditors provide more than a cursory CAM discussion of the estimate in the audit report. Further, managers are more likely to expand their accounting estimate disclosure when strong audit committee oversight of financial reporting exists (Fuller 2016). This finding highlights the continuing importance of the audit committee in its primary role of investor protection. Finally, managers are more likely to expand their accounting estimate disclosures in areas that are highly valued by investors such as disclosing *quantitative* uncertainty information. Quantitative uncertainty information may include items such as the estimate range, the key assumptions used in arriving at the estimate, and sensitivity of the estimate to changes in the underlying assumptions. Enhanced disclosure in these areas provides significant benefits to investors as they quantify the risk in a company's complex accounting estimates.

<u>Question 35.</u> *Are there additional academic studies or data the Board should consider? The Board is particularly interested in study or data that can be used to assess potential benefits and costs.*

We note that Elliot et al. (2016) examine whether investors are willing to pay higher prices for stock in companies where auditors use more expansive CAM reporting, particularly when the content is relevant to the assessment of clients' financial reporting quality. Elliot et al. (2016) theorize that more informative audit reporting lowers the "extraction costs" borne by users in the complex task of assessing financial reporting quality. In their experiment, they find that participants expressed a higher willingness to pay for shares of a mature company exhibiting higher quality financial reporting compared to a growth firm exhibiting lower quality financial reporting. Investors' willingness to pay only increased for the higher financial reporting quality firm when the auditor's report included commentary within the discussion of a CAM which helped investors assess the differing levels of financial reporting quality between the two firms. Elliot et al.'s findings suggest that more expansive auditor reporting benefits not only investors but also improves capital market efficiency, both in general and for individual firms, resulting in higher firm valuation and lower cost of capital for higher financial reporting quality firms.

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Exhibit 1

***Changes* (in blue-type) to Format as per PCAOB's Rel. 2016-003 (Appendix-B, p. A-17). Based on responses to Questions 6(b), 18, and 20.**

To the shareholders and the board of directors of X Company

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

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

We are providing under "Critical Audit Matters" below, information on certain matters we communicated to the Audit Committee, which in no way alters our opinion on the financial statements taken as a whole. We do not provide separate opinions on the critical audit matters, or on the accounts or disclosures to which they relate.

<u>Basis for Opinion</u>

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation

<u>Critical Audit Matters [if applicable]</u>

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

[*Include critical audit matters]*
[Signature] ~~We have served as the Company's auditor since [year].~~ [City and State or Country] [Date]