

Dennis R. Beresford
Executive in Residence
J.M. Tull School of Accounting
Terry College of Business
The University of Georgia
Athens, Georgia 30602-6252
706 542-3502
dberesfo@uga.edu

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Office of the Secretary
PCAOB
1666 K Street N. W.
Washington, DC 20006-2803

Rulemaking Docket No. 34

Dear Board Members:

This letter contains my comments on the May 11, 2016 Proposed Auditing Standard (Exposure Draft or "ED"), "The auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion." I previously commented on the August 13, 2013 ED (my letter dated October 13, 2013) and earlier concepts release (my letter dated July 21, 2011) on the same subject. My comments are based primarily on having served as chairman of the audit committee of five large public companies from 2001 through 2013 as well as having earlier spent 26 years at one of the now Big 4 accounting firms.

Summary

First and foremost, I thank the Board for its very careful consideration of the important issues in this project. Given the earlier concepts release and ED, the Board may well have concluded that it should issue a final standard without further input from constituents. But it obviously has recognized the great public interest in this project and the need to thoroughly vet the significant modifications it has made to the last proposal.

This project has been under consideration for many years after being added to the PCAOB's formal standard-setting agenda in 2010. Its genesis perhaps derives mainly from the 2008 Treasury Advisory Committee report recommending improvements to the auditor's report. But over my fifty plus years in the accounting profession there have been several other calls for change to a report that is usually only a single page in length and provides little detail about the significant work involved in reaching a conclusion that a company's financial statements are

fairly presented. Thus, it is easy to understand the calls from many to make such reports more informative.

At the same time, many of the suggestions for improvement considered over the years have been rejected after determination that they would provide few insights to investors and other users of auditor's reports and possibly create distractions from basic auditing procedures or have other unintended consequences. In that regard, I am pleased that during the current project the PCAOB has rejected the notion of an auditor's discussion and analysis and has deferred, for needed additional study, reporting on other financial information.

I am also pleased that in the latest ED the Board has adopted the recommendation in my 2013 letter that the opinion paragraph be presented first in the auditor's report in order to give it the greatest prominence and to avoid the possibility of its being "lost in the trees" of several pages of critical audit matters (CAMs) and other descriptions about the audit. Further, the required section subheadings are consistent with my suggestion in that same letter of having a table of contents so that readers of the report will be able to easily find what is most interesting to them (presumably, the opinion in most cases). And retaining the basic pass/fail measure of whether the audited company's financial statements are fairly presented is, of course, the most important aspect of the ED and I strongly endorse it.

I also agree with the proposed minor wording changes to the report such as standardizing the addressees and including the phrase "whether due to error or fraud." Consistent with my 2013 letter, however, I do not support two of the key features of the ED: required presentation of CAMs (or a statement that there were none) and required disclosure of auditor tenure. For the Board's CAMs proposal I suggest an alternative that I believe will accomplish the only meaningful aspect of this proposal. For the disclosure of auditor tenure I believe the topic should be removed from this project and left to the SEC to consider in the context of proxy statement disclosure rules. My reasoning for each of these issues is presented in the remainder of this letter.

Critical Audit Matters

A good portion of my 2013 letter was devoted to the reasons why I believed the Board should not require CAMs to be included in auditor's reports. To briefly summarize my reasoning from that letter, I believed:

Auditors would be motivated to over report CAMs in order to avoid later criticism from PCAOB inspectors or others, thus leading to unnecessarily lengthy auditor's reports

Not requiring descriptions of audit procedures related to CAMs may cause readers to infer that auditors are expressing reservations about those matters – a sort of qualification of the overall opinion

Determining the wording of CAMs would require extensive engagement partner/national office time and negotiation with company executives at the time of the audit when meeting SEC deadlines is quite challenging

Audit partners would spend time haggling over wording issues for CAMs rather than spending time on much more important substantive audit matters

In certain cases the auditor would be required to disclose information in CAMs that is not required to be disclosed by the company

Many of the comment letters on that earlier ED had similar or additional reservations about required disclosures about CAMs, particularly letters from company managers and audit committee members. To be fair, the PCAOB has extensively analyzed and addressed those comments in the new exposure draft and has made changes that it believes will mitigate many if not most of the concerns raised. However, of all of the matters listed above, I believe that only the second issue has been truly resolved in the new ED through the required descriptions of audit procedures (which raise other issues as discussed later) and required lead-in language to CAMs in auditor's reports. All of my earlier concerns remain as commented on further below and with reference to comments in my 2013 letter.

I will touch on these concerns in the paragraphs below but first will mention a very important issue that should have been covered in my 2013 letter.

Will CAMs actually present value-relevant information to investors and other users of financial statements? - A good deal of the ED is devoted to the Board's reasoning as to this matter in both the Discussion of the Reproposal and Economic Considerations sections. But all of the discussion seems to boil down to, in my words, "Several users have told us that they would like to have this information. They haven't told us how they would use it and we don't have any compelling evidence that it would help in investment decisions. But some other audit regulators have required this and it might help users analyze financial statements." It is particularly interesting that the first three questions in the Economic Considerations section about CAMs ask how investors would actually use them. And Board member Hanson said in his statement at the meeting at which the proposal was approved, "... it is important that we hear from investors about whether they believe CAM's will provide relevant, helpful information and how that information is likely to be used."

After six plus years of this project, I would have assumed that the Board should know the answer to those questions before proceeding further. It is possible that through this new exposure process the Board will obtain better information about whether and how disclosures about CAMs can assist users. At this point, however, the record would seem to indicate that the Board itself is not entirely convinced about the usefulness of this information.

More specifically, the ED summarizes the current state of play as follows on page 74: "Overall the results from research analyzing whether the information provided in expanded auditor

reporting is useful to investors are limited. Collectively the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements."

On page 64 of the ED, the Board suggests a possible benefit of making these matters more prominent by going on to say this "... could facilitate (investors' and other financial statement users') analysis of the financial statements and other relevant disclosures." And page 70 states that "... the disclosure of previously unknown value-relevant information directly benefits the market because it allows market participants to make better-informed decisions." But in neither of those sections nor elsewhere that I found does the ED explain exactly how the Board thinks the description of audit procedures will provide value-relevant information (except, perhaps, in the case of disclosing some company information that the company hasn't previously provided – see next section).

I did note in the ED's Summary (page 2) that the Board suggests, "For instance, additional reporting by the auditor could facilitate analysis of the financial statements and help investors and analysts engage management with targeted questions about critical audit matters (emphasis added)." I agree that drawing more attention to critical accounting policies and estimates may be a good idea (see my modest proposal below). But questions the company responds to should be about its financial reporting and not the approach the independent auditor has taken to become satisfied with that reporting. Suggesting that investors and analysts will have targeted questions about critical audit matters seems to confuse the respective responsibilities of the reporting company and the independent auditor.

SEC proxy statement rules require that registrants must state whether representatives of their principal auditing firm are expected to attend the annual meeting and whether those representatives will have the opportunity to make a statement or respond to questions. Having attended a few dozen annual meetings as a board member, I have never heard a shareholder ask a question of the auditing firm representatives attending the meeting. And in informal discussions with other audit committee members they indicate similar experiences. (If this is considered relevant input for the current project I'm sure the PCAOB could quickly survey practice and find out whether my experience is common or not.) This causes me to conclude that while shareholders are very interested in the credibility added to financial statements through the annual audit, they aren't really interested in the details of what went into arriving at the auditor's opinion because they would derive no added value therefrom.

Auditor's opinions shouldn't initially report company information – As noted earlier, one of my comments on the earlier ED was that in certain cases the auditor would be required to disclose information in CAMs that is not required to be disclosed by the company. This was a concern shared by many commenters. The new ED addresses this in Note 2 to the draft standard: "When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was

addressed in the audit¹ (emphasis added)." This is explained further in Board member Ferguson's statement as "... additional information is confined to what the auditor did in the audit and the principal reasoning behind key facets of the audit – all activities within the exclusive purview of the auditor."

While the position in the new ED is obviously an improvement, it is still objectionable. In short, it has the practical effect of mandating corporate disclosures in certain cases, which I believe is not within the PCAOB's purview.

The part of the Sarbanes-Oxley Act of 2002 that calls for the establishment of the PCAOB says this about its scope of activities: "There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." The Board essentially repeats this in its Mission by stating: "The PCAOB mission is to oversee the audits of public companies in order to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

Thus, both the law and its Mission make clear the Board's responsibility for the form and content of independent audit reports. And while it is clearly the Board's responsibility to continue efforts to improve the informative value of auditor's reports, it has long been established in the law that the Securities and Exchange Commission (with reliance on the Financial Accounting Standards Board for most aspects of Generally Accepted Accounting Principles) has the responsibility for the form and content of company financial and other information necessary to properly inform investors. Therefore, any changes to the auditor's report to make it more useful to investors in public company financial statements must be limited to matters relating to the audit and not provide additional information that wouldn't have otherwise been provided by the reporting company. The exception in Note 2 is, accordingly, inappropriate and should be deleted.

Further, the exception in Note 2 isn't really necessary based on other PCAOB auditing standards. That is, if a company should omit a disclosure that is material in relation to the presentation of the overall financial statements, the auditor would be required to issue a qualified opinion. In my experience, in the very rare cases where this might have happened in practice, the leverage that this requirement provided to the auditor always resulted in the company and the auditor

¹ In this regard I note the analysis of the ED prepared by the Gibson Dunn law firm. In referring to this matter, Gibson Dunn states, "This note says that the auditor will not be expected to provide information about the company that has not been made publicly available by the company 'unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.' Companies and audit committees may wish to consider whether this exception in effect nearly swallows the rule, and if so, what disclosure considerations may be implicated, including whether it would put the auditor in a position of having to make disclosures in the first instance about any number of matters, such as loss contingency considerations or investigations."

reaching a meeting of the minds as to appropriate disclosure. Thus, in my opinion, the exception covered by Note 2 should be deleted from any final standard on the basis that (1) it is not within the PCAOB's jurisdiction to require company disclosures, and (2) the exception is unnecessary based on other, existing auditing standards.

Illustrating concerns by reference to examples – To help explain my continuing concerns about disclosure about CAMs, let me focus on the two illustrative examples that are included on pages 32-35 of the ED.

Company A's example is that of the allowance for loan losses for a loan product. While the first paragraph of the example does make reference to the company's financial statements, that paragraph also provides extensive information about the new loan product, including its percentage of the loan portfolio and how the company has developed an allowance for losses. While there is insufficient context for me to properly evaluate that description, it appears that the example provides information that would not normally be included in a note to the financial statements. More likely, the details about how much of the portfolio consists of this new category of loans would be included in MD&A. And any description of how the company has developed an allowance for losses would also be included in MD&A, assuming it was one of the critical accounting policies and estimates, which it may well not be.

It may be that the PCAOB intends this paragraph to illustrate the application of Note 2 to the draft standard as discussed earlier. If so, that explanation should be added because otherwise this example appears to go well beyond the guidance in the ED of "Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter."

There is also the issue of redundancy between what the company plans to say about this matter in the financial statement footnotes or elsewhere in the 10-K and what the auditor says in the CAM. At a minimum, having to coordinate any such language will lead to extensive discussions between company management, both financial and legal, and senior partners at the accounting firm, including national office representatives. In an ideal world, these discussions will take place well before year end so that the parties know what each plans to include in their report. But the pressures of completing an audit under tight SEC deadlines often result in matters that weren't fully planned at an earlier date. Haggling over wording issues could easily distract the engagement partner from attention to wrapping up more important, substantive auditing issues when facing these deadline pressures.

Moving beyond that opening paragraph for the Company A example, the next two paragraphs are more or less boilerplate simply describing why the new loan category is a critical audit matter and a lead in to the audit procedures.

The final two paragraphs cover the audit procedures performed per the draft standard requirement to "Describe how the critical audit matter was addressed in the audit." These sentences could be summarized as, "With the involvement of a specialist, we tested the reasonableness of the company's estimates and their computational accuracy." It's certainly

possible that drawing readers' attention to these accounting estimates through mentioning them in the auditor's report will cause those readers to think more about these matters. However, I don't see how describing audit procedures will provide any further value-relevant information, particularly such summarized and generalized descriptions.

Further, while adding a description of audit procedures does address the concern I mentioned in my earlier letter about readers possibly inferring reservations about the matters listed, I now have the opposite concern. That is, notwithstanding the required lead-in caveat, I believe that readers will likely interpret the inclusion of audit procedures for CAMs as a form of implicit opinion that each one is fairly stated on its own and not just in the context of the overall financial statements.

Company B's example – begins with a brief reference to financial statement footnotes. However, the second paragraph then discloses certain information that arguably ought to be provided by the company or perhaps already was. Apparently, the inclusion of this information, which seems inconsistent with limiting CAMs to material within the purview of the auditor (see above), is needed in order to explain why this is a critical audit matter although that isn't clear. If the Board moves forward with the notion of CAMs in a final standard and includes examples along these lines it could help if it would explain why the various matters have been included, perhaps by cross references to the applicable sections of the standard.

The three paragraphs describing audit procedures go into a bit more detail than those for the first example. However, they are still general in nature and provide no quantitative or other information that could be used by an investor to "facilitate analysis of the financial statements" or otherwise do more than draw their attention to this being an important area of the company's accounting.

Possible chilling effect on communications – As a former audit committee chairman I would be concerned about any PCAOB action possibly having a chilling effect on communications between the committee and the independent auditors. The revised proposed documentation requirement is one that could have that effect. I'm confident that auditors would continue to communicate about the matters that truly belong in critical accounting policies and estimates, material unusual items, and the like. However, requiring that only those communicated need be documented could cause matters on the margin to be left out of communications so as to avoid even more documentation or PCAOB inspection second guessing of the documentation. On the other hand, the fact that all matters communicated to the audit committee have to be documented would seem to encourage auditors to err on the side of including all such items in their reports rather than leaving out some matters that qualify for communication but don't seem to require inclusion in the report.

This seems to lead to a sort of "damned if you do, damned if you don't" situation. It's hard to predict whether auditors will be like Goldilocks and get it "just right," but I suspect that in most cases we would find that the response is "too much" with at least some being "too little."

One other matter – While I do not favor even more additions to the auditor's report, I must comment on the Board's reasoning on page 52 in response to a couple of letters on the earlier ED that suggested an auditor's report should provide additional explanations about certain key elements of the report. The Board states, "Since it may not be practical to describe these elements concisely, adding these to the auditor's report would unnecessarily lengthen it without providing additional useful information to investors." I think that many (if not most) from the corporate world would apply that same reasoning to the whole notion of CAMs!

While I clearly do not support requiring the presentation of CAMs in the auditor's report, I believe that perhaps the most important aspect of the reasoning for requiring CAMs can be accomplished in a greatly simplified manner and I present that suggestion now.

A modest proposal – As noted, I believe the inclusion in the auditor's report of several, lengthy CAMs is not likely to provide value-relevant information to investors and other users of those reports. Further, there are costs and unintended consequences that are likely to ensue. But I believe that the major benefit of the proposal, focusing more user attention on the significant accounting policies and estimates section of the 10-K, can be accomplished with a simple solution that has essentially no costs or other consequences. That would be for auditor's reports to merely refer to the applicable section of the 10-K or, alternatively, list the policies and estimates included by the company.

For example, the next to last sentence in the Basis for Opinion section of the proposed auditor's report now states, "Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements." A sentence could be added along the lines of, "The most important of these principles and estimates are presented on pages ___ to ___ under Critical Accounting Policies and Estimates."

I would prefer the above approach as it is simple, straight-forward, and avoids any implication of separate auditor assurance on the individual critical accounting policies and estimates. However, those aspects of the company's reporting will always be among those to which the greatest attention is given during the audit. Therefore, even if readers would infer a degree of specific assurance about the individual items by their being listed separately in an approach similar to that in the next paragraph, I think this would be an acceptable alternative.

The alternative of listing the critical accounting policies and estimates individually would give these matters somewhat more emphasis and could be provided along the following lines using the examples from the March 31, 2013 Legg Mason 10-K as described in my 2013 comment letter:

The most important of these principles and estimates are presented on pages ___ to ___ under Critical Accounting Policies and Estimates and are:

- Consolidation (variable interest entities)
- Revenue recognition
- Valuation of financial instruments
- Intangible assets and goodwill
- Stock based compensation
- Income taxes (recovery of deferred tax asset)

This suggested approach is somewhat similar to Auditor's Association with Portions of MD&A as discussed on page 93 of the ED as one of the policy choices considered but rejected by the Board. However, the important difference is that I am not suggesting the auditor provide separate assurance on the critical accounting policies and estimates. I am only recommending that they be highlighted in the auditor's report so that users of the report can appropriately go to the company's section of the 10-K where these matters are discussed by the party that has responsibility for them. As noted above, I believe this will accomplish what the Board suggests is one of the principal objectives of CAMs – drawing readers' attention to the most important accounting policies and estimates – without any related costs or unintended consequences.

I have long thought that the critical accounting policies and estimates section was one of the most important parts of the 10-K. For someone wishing to have a broad understanding of a company's reporting I would strongly suggest reading that part of the document before looking at the financial statements or other financial data. Enough attention probably hasn't been paid to this valuable section of the 10-K by investors, analysts, and other interested readers. So a requirement to highlight that section of the 10-K in the auditor's report could be quite useful without creating some of the other problems referred to above.

Auditor Tenure

As noted in my 2013 letter commenting on the earlier ED, "Audit firm tenure 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." That continues to be my position.

The current ED carries forward the earlier proposal but adds no convincing reasoning beyond what was stated in the earlier proposal. It seems to boil down again to (slightly rewording my earlier letter) (1) some users want this information and think it will be useful, (2) there is some research that this information may be relevant but the research doesn't give a conclusive answer, and (3) it would cost almost nothing for auditors to do this. In response to this line of thinking, two of the five Board members continue to have reservations and apparently share my view that the record developed to date does not support this portion of the ED.

The Board does offer the alternative of the tenure information being presented on Form AP. This strikes me as a "least bad" solution. As summarized above and in my earlier letter, if presented at all I think logic would call for its inclusion in the proxy statement in connection

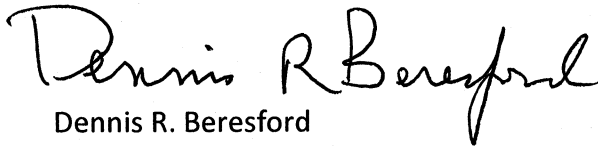
with shareholder votes on ratification of selection of the independent auditors by the audit committee. Putting it in Form AP at least avoids further muddying up the auditor's report with irrelevant information. But I would greatly prefer that the PCAOB leave it to the SEC to decide whether this is something that should be addressed in the context of annual meeting proxy statement disclosures.

Conclusion

While the PCAOB has spent many years on this project, I urge careful consideration of the comments received on this ED. Board member Harris hopes for a vote on a final standard by year end 2016. That might be possible if there are relatively few comment letters or most don't have significant concerns about the ED. However, the normal process of reading and analyzing the comment letters and then redeliberating any significant issues would seem to call for at least a bit more time. This is one of the Board's most important projects and it should make every effort to get it right.

Please let me know if you have any questions about the contents of this letter.

Sincerely,

A handwritten signature in black ink that reads "Dennis R. Beresford". The signature is written in a cursive style with a large, prominent "D" at the beginning.

Dennis R. Beresford
Executive in Residence