



1800 Gateway Drive, Ste 200
San Mateo CA 94404-4072
(800) 922-5272
www.calcpa.org

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Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

comments@pcaobus.org

Subject: Comments on PCAOB Rulemaking Docket Matter No. 034
Proposed Auditing Standard – The Auditor’s Report on an Audit of
Financial Statements when the Auditor Expresses an Unqualified Opinion
And Related Amendments to PCAOB Standards

The California Society of CPA’s (“CalCPA”) Accounting Principles and Assurance Services Committee (the “Committee”) is the senior technical committee of CalCPA. CalCPA has approximately 43,500 members. The Committee consists of 55 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee is pleased to provide its responses to the questions raised by the PCAOB in the repropoed standard. However, a significant number of the Committee’s members are opposed to the proposed requirement to include critical matters (“CAMs”) in the auditors’ report. As stated in the Committee’s letter of November 23, 2013 on the original PCAOB Rulemaking Docket Matter No. 34, inclusion of CAMs in the auditors’ report will lead to perceived differences in audit quality where such perception should not exist, and identifying CAMs would duplicate disclosure already included (or should have been included) in annual reports under risk factors, management’s discussion and analysis and summary of significant accounting policies, which are often currently duplicative already. The Committee also has continuing concerns over the use of CAMs by the plaintiff’s bar in asserting claims against auditors; this is a far more severe concern in the United States than it might be in certain foreign countries where a more expansive auditors’ report has been adopted in practice. Please refer to our November 23, 2013 letter for more information.

IV. Discussion of the Reproposal

A. Auditor Communications of Critical Audit Matters:

1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? **Yes.** Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern. *The Committee believes the proposed definition is fine.*

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

Yes, as the auditor currently has a responsibility to identify and discuss such matters with the audit committee. It is a natural extension of communications currently being made under AS 1301 – Communications with Audit Committees

b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.

Yes, but the proposed definition addresses this by its further qualifications.

c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?

The Committee believes that materiality is a matter of judgment, but the phrase is appropriate and clear.

d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?

The Committee believes this phrase is ambiguous and will be interpreted differently by different people. The Committee believes it might be better to expand the definition by including examples, e.g. items requiring consultation, items questioned by the EQR, etc. The Committee strongly recommends that sufficient interpretive materials be provided to supplement the new standard.

2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?

Yes, factors such as those suggested in the Committee's response to Question 1.d. above, will be helpful but are items to be "taken into account" which is softer than saying something definitive.

3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?

See the Committee's response to Question 1.d. above.

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 reaudit? Why or why not?

Yes, but not as contemplated by the question. The Committee believes the auditor should be required to communicate in the current period only matters of continuing relevance or if a matter previously reported as a CAM is resolved in the current period in a manner materially different than how it was handled in the period in which the CAM was originally reported.

5. Are the repropoed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?

The Committee believes the repropoed requirements are sufficiently clear.

6. Do the reposed 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, and

The Committee does not believe it is the auditor's responsibility to disclose original or confidential information. If such information is considered necessary to be disclosed to understand a CAM, that information should be disclosed by the registrant in the financial statements or footnotes (see the Committee's response to Question 7 below).

- 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? Are there other steps the Board could take to address these concerns? If so, what are they?

The Committee does not believe the reposed standard can fully mitigate a third party's misunderstanding regarding the communication of CAMs. The Committee also believes that all CAM disclosures will subject the auditor to being second-guessed with the benefit of 20/20 hindsight. Perhaps the PCAOB, in conjunction with the SEC, could devise a "safe harbor" to protect auditors from lawsuits related to the disclosure of CAMs.

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?

No. The CAM definition is qualified as being related to matters with the potential for material misstatement of the financial statements. This suggests that all appropriate disclosure should be within the financial statements, including the footnotes.

8. Is it appropriate for the reposed 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?

Yes, but the Committee believes it is presumptuous to assume that every audit contains at least one CAM.

9. Is the reposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?

The Committee believes the reposed documentation requirement is clear. However, documenting the negative would ultimately always come down to something like, "in our (i.e. "the auditors") judgment"

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

Given the potential for misunderstandings, the biggest risk associated with the PCAOB's proposal to expand the auditor's reporting model is increased litigation and the unwarranted increase in private liability arising from the disclosure of CAMs. As the Committee suggested in our response to Question 6.b. above, perhaps the

PCAOB, in conjunction with the SEC, could devise a "safe harbor" to protect auditors from unwarranted and frivolous lawsuits related to the disclosure of CAMs.

11. Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?

All of the "changes" addressing this issue are auditor judgment qualifiers, i.e. they are all subject to legal challenge. The reproposal may be a bit better, but it won't make much difference if there is litigation.

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?

Yes. The Committee suggests having the audit committees indicate, as a matter of public record, its acceptance of the auditors' discussion of CAMs. Please refer to the Committee's ' response to Question 6(a).

B. Additional Improvements to the Auditor's Report

13. (a) Is the repropose requirement relating to auditor independence clear? (b) Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?

(a) Yes

(b) No. The auditors' report already uses the caption "independent auditors' report". Therefore, including similar wording within the body of the report is redundant and unnecessary.

14. (a) Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? (b) Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?

(a) This is fine, however, please refer to the Committee's response to (b) below.

(b) The auditors' report is intended for general use. Therefore, why address it to any one or two particular users?

15. Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?

See the Committee's response to Question 14.

16. Are the repropose requirements for information regarding auditor tenure (a) appropriate and (b) 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?

(a) The Committee believes this information should not be included in the auditors' report as it is included in the new Form AP.

(b) See the Committee's response to (a) above. .

17. Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?

The Committee believes that disclosing audit tenure within the components of investment companies to be useful information. However, this information should be considered for

disclosure in Form AP. By moving this disclosure out of the report and into Form AP, more detail can be provided when relevant, without cluttering up the auditors' report.

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

Yes. Please refer to the Committee's responses to Questions 16 and 17.

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

(a) Not significantly

(b) Use Form AP, not the auditors' report

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?

The Committee does not see any substantive changes in the form and content of the basic auditors' report that warrant any comment.

C. Explanatory Language and Emphasis of a Matter

21. Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?

Yes

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?

EOMs are about matters handled appropriately in the financial statements to which the auditor wants to draw the reader's attention. They are not necessarily a CAM. The opposite is also true; every CAM does not require an EOM. Therefore, the Committee believes they should be separate, not integrated.

23. Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?

Yes.

24. Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?

Yes. However, please see the Committee's response to Question 22.

D. Information About Certain Audit Participants

25. (a) Would the repropoed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? (b) Should the standard allow more or less flexibility in the presentation of the auditor's report?

(a) Yes

(b) *In this regard, the Committee believes that a standard order of presentation is desirable.*

V. Amendments to Other PCAOB Standards
B. Other Amendments to PCAOB Standards

26. Are the repropoed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the repropoed standard that the Board should consider? If so, what are they?

The Committee has no input on the specific details of the proposed amendments aside from asking the PCAOB to reconsider the need to disclose CAMs, as suggested in the Committee's introduction to this letter.

VI. Economic Considerations
E Alternatives Considered, Including Policy Choices Under the Reproposal

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?

The Committee cannot comment on this question. It is for users to answer.

28. How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?

See the Committee's response to Question 27.

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

Although really for users to answer, a possibility is that CAM disclosures would reveal something about management's appetite for risk.

30. Would critical audit matters be useful in assessing audit quality? If so, how?

The Committee believes that audit quality is assessed with the benefit of 20/20 hindsight. The identification of CAMs and whether they were properly handled will also be evaluated with the benefit of 20/20 hindsight.

31. (a) 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? (b) Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?

a) *Maybe. Once a matter is identified as a CAM, it will undoubtedly receive extra attention.*

b) *See the Committee's response to Question 30 regarding audit quality, and Question 6 (a) regarding management's disclosures. The Committee cannot respond on behalf of investors.*

32. Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?

The Committee cannot comment on this question.

33. Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?

The Committee believes the number of CAMs reported will likely vary based on the size and complexity of the company as well as the size of the accounting firm. The Big 4 may be less likely to conclude that matters "involved especially challenging, subjective or complex auditor judgment" due to their deep technical resources, while smaller public companies who employ the services of smaller accounting firms could find more issues to be sufficiently challenging and complex requiring inclusion as a CAM.

34. Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?

See the Committee's response to Question 33. If the Committee's view is correct, the Big 4 could promote their vast resources of highly experienced personnel as a means of to reduce the number of matters being considered CAMs.

35. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

The Committee is not in a position to comment.

36. Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?

None that the Committee is aware of, other than as stated in the introduction to this letter regarding substantially increased risk of litigation against auditors.

VII. Exclusions from Critical Audit Matter Requirements

37. Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?

Considering the definition of a CAM, the Committee believes it is applicable to every audit.

38. For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?

It is possible, since management's appetite for risk may be perceived through the identified CAMs.

39. While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?

The Committee believes it should be required, not encouraged.

40. Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies? Why or why not?

No, for the same reason the Committee stated in our response to Question 37.

VIII. Considerations for Audits of Emerging Growth Companies

41. (a) Should the repropoed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? (b) Should the other elements of the repropoed standard and amendments be applicable for the audits of EGCs? (c) Should the repropoed requirements be modified to make their application to EGCs more appropriate? (d) Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?

- (a) Yes
- (b) Yes
- (c) No
- (d) *If the concept of CAMs is valuable to any investors, it is valuable to all investors.*

42. If the Board determines not to apply all or part of the repropoed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?

It would raise questions about why some are and some are not.. The Committee believes any final rules in this area should be applied consistently.

43. Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the repropoed standard to audits of EGCs?

The Committee has no comment.

44. (a) If the repropoed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? (b) Should the Board consider a delayed compliance date for the repropoed standard, or for certain parts of the repropoed standard, for audits of smaller companies? (c) If so, what criterion should the Board use to classify companies, for example smaller reporting companies? (d) Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?

- (a) *The Committee suggests at least twelve to eighteen months at a minimum.*
- (b) Yes
- (c) *Yes, something based on market capitalization*
- (d) No

We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,



A.J. Major III
Chair
Accounting principles and Assurance Services Committee
California Society of Certified Public Accountants