ICGN
International Corporate Governance Network

12 August 2016

To: **Public Accounting Oversight Board**

Re: **Comment letter on PCAOB's The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion proposal**

Via email: comments@pcaobus.org

The International Corporate Governance Network (ICGN) welcomes the opportunity to comment on the PCAOB's The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion proposal.

ICGN was founded 20 years ago and is an investor-led membership organisation of more than 650 individuals based in 46 countries from around the world. Our mission is to inspire and promote effective standards of corporate governance and investor stewardship to support the sustainable value creation of companies and to advance efficient markets and economies world-wide. Our members represent institutional investors with global assets under management in excess of US$26 trillion. Accordingly, ICGN's members offer a source of practical knowledge and experience with regard to governance and investment issues. ICGN's Accounting and Auditing Practices Committee supports ICGN's policy positioning in matters relating to financial reporting, accounting matters and audit quality. For more information on the ICGN, please visit www.icgn.org.

ICGN fully supports the PCAOB's efforts to enhance the relevance and value of the audit for users and the public by stimulating greater transparency about the work carried out by auditors in the course of auditing financial statements. We believe extending auditor reporting is a key objective that will further strengthen investor protection when using financial statements in making informed investment decisions.

ICGN supports the retention of the current "pass/fail" model which provides investors valuable insight into the small percentage of companies with a qualified opinion. However, ICGN believes the current model can be improved upon for the vast majority of companies with an unqualified opinion by extending the auditor's report to include more audit-specific information for investors. The ICGN believes the new critical audit matters format will provide investors with relevant information related to the independent audit of a company's financial statements.

ICGN is encouraged by enhancements to the auditor's report globally. We would highlight in particular as a positive example the UK's independent auditor's report that requires auditors to provide an overview of "those risks of material misstatement that were identified by the auditor, and which had the greatest impact on the audit strategy, resources required and the work of the engagement team; the application of materiality; and the scope of the audit, including how it responded to the risks of material misstatement and the application of materiality". We believe this report has led to meaningful information disclosure, and has relevance to companies globally.

ICGN is supportive of the enhanced audit report, complemented by enhanced reporting by the audit committee - which is required to report on "the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed." Auditors are required to report by exception if the section in the annual report describing the work of the audit committee "does not appropriately address matters communicated by the auditor to the audit committee." We believe this mitigates the duplicate or dueling information that might arise in disclosures by the audit committee and the auditor's report and maintains important distinctions between their respective roles and responsibilities. In addition, we anticipate the IAASB's new requirement for the auditor to discuss Key Audit Matters will be a positive for investors and look forward to seeing how the new requirements are received in the marketplace.

Critical Audit Matters

ICGN supports the rationale for determining and communicating critical audit matters (CAMs).

The key to determining the right number of CAMs is the balance between too little and too much information. ICGN believes the definition of a CAM as a matter communicated or required to be communicated to the audit committee that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment is appropriate and aligns the scope and definition with the Key Audit Matters under the UK and IAASB models.

From ICGN's perspective the expanded UK auditor's report has found the right balance in the amount of information that the auditor provides. According to the PCAOB staff study cited in the PCAOB Proposal, "on average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight." In many UK auditors' reports, the new requirements generally have resulted in meaningful and targeted information for investors while avoiding information overload.

Given that the determination of the CAMs is based on a principles-based framework, we believe the "accounts or disclosures that are material to the financial statements" hurdle is appropriate. Given the US legal system, if the hurdle to determine what CAMs are communicated is too low, for example to include immaterial matters, then there is a high probability the auditor's report could result in too many topics communicated as non-critical audit matters. If that were to occur, the CAMs disclosed in the auditor's report could become a repeat of the excessive boilerplate risk factor disclosures that are included in some US company annual reports. Maintaining a principles-based framework that allows for auditor judgment for reporting CAMs also is important to avoid descriptions of CAMs from becoming boilerplate over time and avoids impeding innovative improvements in auditor reporting.

Auditor Tenure

The ICGN believes the reporting of auditor tenure could be beneficial for investors. Although the proposal notes some observers contend the information may lead to inaccurate assumptions that tenure is related to audit quality, we do not share that opinion. Consistently disclosed information on auditor tenure may be viewed as relevant by some investors in their analysis of a company.

The release also notes a growing trend towards voluntary disclosure of auditor tenure and cites a study by the Center for Audit Quality, together with Audit Analytics, that reviewed corporate proxies and which "identified that in 2015 and 2014 auditor tenure was disclosed in the annual proxy statements of 54% and 47% of the S&P 500 companies, respectively" (page 48-49). Moreover, the ICGN's Global Governance Principles (section 7.7) calls for companies to publish their policy on auditor rotation.

Auditor Independence

ICGN questions whether the proposed statement on auditor independence will yield any incremental benefits or insight to investors. The proposal notes, "the proposed standard would require the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB."

As the proposal notes, the UK FRC "requires the auditor to state that the auditor is required to comply with the UK's ethical standards for auditors, which include requirements regarding auditor independence". An example of an independence statement from the auditor's report disclosed in Tesco's 2016 annual report is shown below:

Independence. We are required to comply with the Financial Reporting Council's Ethical Standards for Auditors and we confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the prohibited non-audit services referred to in those standards.

In our opinion, there is little decision useful information in the Tesco independence attestation, though ICGN members see the benefits of the underlying process that supports this form of disclosure. We would recommend the PCAOB review UK company independence statements to determine how these statements may better include decision-useful information for investors. It is logical to assume that most if not all auditors will claim they abide by the FRC requirements; if that is the case then boilerplate disclosure of this nature may not be informative.

If the PCAOB decides to move forward with proposed changes to enhance the wording of the auditor's report in relation to independence, we encourage the PCAOB to consider aligning the required communication with IAASB standards. These would include expanded descriptions of the responsibilities of management and those charged with governance, as well as the auditor's responsibilities, in separate sections of the report. We believe these changes could enhance users' understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain, and would promote consistency of auditor reporting globally.

We hope that these comments are useful in your deliberations and the ICGN Policy Director, George Dallas (george.dallas@icgn.org), would be happy to elaborate on any of the points raised in this letter. Thank you for your consideration.

Yours truly,

Erik Breen
Chairman
International Corporate Governance Network
Erik.Breen@triodos.nl

ICGN contacts:

Kerrie Waring, Executive Director, ICGN: kerrie.waring@icgn.org

Cindy Fornelli, ICGN Accounting and Audit Practices Committee: cfornelli@thecaq.org

Saffron House 6-10 - Kirby Street - London - EC1N 8TS - UK
VAT No. 927 1665 09 | Registered in England No 6467372
t: +44 (0)207 612 7011
f: +44 (0)207 612 7085
e: secretariat@icgn.org
w: www.icgn.org
@ICGNCorpGov
ICGN