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August 15, 2016

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

Re: PCAOB Release No. 2016-003; 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 the Related Auditor's Report; and Related Amendments to PCAOB Standards*

Ladies and Gentlemen:

The Public Company Accounting Oversight Board (the "Board" or "PCAOB") has solicited public comment on the reproposed auditing standard and other matters discussed in PCAOB Release No. 2016-003 (the "Reproposal") dated May 11, 2016. We appreciate the opportunity to comment on the Reproposal and the important issues it raises.

I. Introduction

We continue to welcome the Board's efforts to make the financial statements and the related auditor's report more relevant to investors. As we discussed in our prior comment letters in respect of PCAOB Release No. 2011-003, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (June 21, 2011) (the "2011 Release")[1] and PCAOB Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (August 13, 2013) (the 2013

[1] Comment letter of Cleary Gottlieb Steen & Hamilton (Oct. 14, 2011) (the "2011 Comment Letter"), available at http://pcaobus.org/Rules/Rulemaking/Docket034/149_Cleary_Gottlieb.pdf.

Release")[2], our perspective on these matters is informed by our role as legal advisers who are intimately familiar with both the fundamentals and the nuances of the federal securities laws, including how they apply to financial and other disclosures, and who represent issuers and others in connection with a wide variety of matters. These matters include advising issuers on their reporting obligations (including financial disclosures); advising audit committees on their responsibilities and best practices; and advising issuers and underwriters in connection with a wide variety of capital markets transactions to which the federal securities laws apply. Financial reporting, including its reliability and relevance, is often a critical element of these matters.

In drafting the Reproposal, the Board attempted to contour the reproposed auditing standard to the concerns raised by various constituencies in comment letters related to the 2013 Release. However, the Reproposal does not adequately respond to two main concerns raised by us and others. First, under the Reproposal, the auditor can be required to provide original disclosure about an issuer, a concern we raised in our 2011 Comment Letter and reiterated in our 2013 Comment Letter. Second, the auditor will be required to report critical audit matters in a manner that raises a significant likelihood, which neither the Board nor the Commission should find acceptable, that communications will be chilled between the audit committee and management, on the one hand, and the auditor, on the other.

As we stated in our 2011 Comment Letter and our 2013 Comment Letter, we are and remain dedicated to full and fair disclosure under federal securities laws, particularly when that disclosure relates to financial reporting and transparency to investors and markets, including improvements in financial reporting that are fostered by the application of robust auditing standards. However, we believe fair disclosure, transparency and the interests of investors must be considered against the backdrop of legitimate issuer concerns, including the commercial sensitivity of disclosing certain matters. We also believe disclosure requirements regarding issuer information, and the consideration of interests they entail, should remain the province of the Securities and Exchange Commission (the "Commission") in its application of the federal securities laws.

While we commend the Board for undertaking to refine the 2013 Release to address concerns raised through the comment letter process, including concerns contained in our 2013 Comment Letter, and recognize there are improvements when comparing the Reproposal to the 2013 Release and 2011 Release, we believe the Reproposal inadequately addresses some key concerns. We describe our concerns in greater detail in Section II below. [3]

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[2] Comment letter of Cleary Gottlieb Steen & Hamilton (Dec. 23, 2013) (the "2013 Comment Letter"), available at https://pcaobus.org/Rulemaking/Docket034/231b_CGSH.pdf.

[3] We also reiterate several important principles noted in our 2013 Comment Letter and our 2011 Comment Letter that the Board should keep in mind as it continues to refine the Reproposal and when considering any changes to the auditor's report and the processes and interactions that may result from those changes. These principles include: i) original disclosure about an issuer should be the responsibility of, and come from, the issuer and not any third party, including the auditor; ii) there should be no adverse impact on the relationship or structure of interactions between management, the audit committee and the auditors as a result of any changes to the auditor's report or role; iii) the pass/fail model should not be undermined; and iv) a cost/benefit analysis should be undertaken rigorously, in which the costs of any change, including the adverse impact on the foregoing principles, must be justified by the benefit of significantly improving financial reporting that would result from any change to the auditor's report or role.

II. The Reproposed Auditing Standard Raises Two Significant Concerns

The Board's auditing standard, as reproposed, continues to be highly problematic in two significant respects: it will require auditors to provide additional original information about the issuer, even if such information is commercially sensitive and not required to be disclosed by the federal securities laws or the Commission's rules and regulations thereunder; and it will chill communication between the audit committee and management, on the one hand, and the auditors, on the other. Failing to address these concerns in a more meaningful way than reflected in the Reproposal will impose a cost on the disclosure process that in our view outweighs any benefit provided by the additional information proposed to be required in the auditor's report.

A. The Reproposed Auditing Standard Provides an Obligation that Auditors Expand the Scope of Existing Disclosure Regarding Issuers in a Manner that Supersedes Management's Responsibility for Disclosure, Ignores Valid Concerns Surrounding Commercial Sensitivity and Sidesteps the Commission's Authority to Determine Disclosure Requirements.

One of our most significant concerns, dating back to the 2011 Release and the 2013 Release, and continuing in the Reproposal, is that the Reproposal, if adopted as proposed, would require the auditor to disclose, and to be the source of, additional original information about an issuer. The intention of the Reproposal is to "respond to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report, without imposing requirements beyond the auditor's experience or mandate,"[4] and the PCAOB believes it has "not change[d] the auditor's current role of attesting to information prepared by management."[5] However, the requirement for auditors to be the authors of original disclosure of issuer information still exists in important, explicitly specified respects, where "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."[6] It is counter-factual to believe disclosure in those specified circumstances will be limited to a description of audit-related matters that will not involve substantial disclosures of original issuer information. This will change the role of the auditor from its role as attester to management disclosure, and introduces a role that will influence the direction and content of disclosure, even though the Reproposal requires fewer instances in which auditors will be obligated to disclose original information about an issuer compared to the 2013 Release.

Any change to the auditor reporting model should keep the responsibility for disclosure about an issuer where it belongs, with the issuer.[7] The Commission agrees that

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[4] Reproposal, p. 2.
[5] Reproposal, p. 5.
[6] Reproposal, p. 35.
[7] As we noted in the 2011 Comment Letter and the 2013 Comment Letter, the Treadway Commission's 1987 report squarely placed the primary responsibility for an issuer's financial statements on management, and made clear that independent public accountants play a secondary role. In addition, it is clear from the Reproposal that other commenters felt similarly uncomfortable with the concept of auditor authored-original disclosure about an issuer, as the Reproposal notes that "[generally] preparers, audit committee members and auditors were not supportive of adding company-specific information to the auditor's report" and felt that management should be the primary source of disclosure. See Reproposal, p. 6.

oversight of issuer disclosure is a Commission responsibility and not the province of the PCAOB. In discussing PCAOB Release No. 2013-009, *Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits* (Dec. 4, 2013), the Commission opposed disclosure of auditor information anywhere other than the auditor's report, stating that "requiring any disclosure by the audit committee would require [Commission] action because the PCAOB does not have authority over issuer disclosures."[8] While the Reproposal does not purport to require an auditor to author disclosure anywhere outside the auditor's report, it is clear, as discussed below, that the Reproposal would require auditors to provide information about an issuer that the issuer had not previously made public, and whether that is part of or outside the auditor's report seems irrelevant to whether the Commission rather than the PCAOB has the authority to require it.

The Commission is the more appropriate body to consider and weigh the costs and benefits of requiring sensitive disclosure about an issuer and to judge the circumstances under which disclosure that may be contrary to an issuer's self-interest is required nonetheless. In the recent Commission release, "*Business and Financial Disclosure Required by Regulation S-K*,"[9] the Commission describes the costs and benefits of requiring disclosure, weighing the interests of investors and issuers. The benefits of additional disclosure, such as reducing information asymmetries between management and investors that results in more efficient investments and voting decisions and increases integrity of the securities markets, must be weighed carefully against the costs to issuers, including the incremental costs of producing the additional information, subject to appropriate controls, and the competitive harm that can result from such disclosure. The PCAOB has in many respects responded to the concerns raised by different constituencies throughout the comment process, but the Reproposal does not adequately consider the costs to issuers and the potential resulting harm as a result of requiring disclosure that issuers do not control and is not otherwise required by the Commission. Although the Reproposal undertook efforts to mitigate the extent of original disclosure of issuer information by auditors, the Reproposal does not address the key issues of superseding management control over the company's disclosure and the Commission's primary role in overseeing disclosure regulation.

The Reproposal argues that improvements it makes from the 2013 Release limit the amount of original disclosure of issuer information an auditor may be required to disclose; however, they by no means ensure that the auditor's responsibility ends where management's responsibility begins. While the Reproposal states that "the auditor is not expected to provide information about the company that has not been made publicly available by the company,"[10] the Reproposal countermands that statement by continuing, as noted above, "unless such information is necessary to describe the principal considerations that led an auditor to determine a matter is a critical audit matter or how the matter was addressed in the audit."[11] To illustrate the possibility, the Reproposal provides, "[f]or example, in describing the principal considerations that led the auditor to determine that revenue recognition is a critical audit matter, it is possible that the auditor could provide more information than is provided in management's disclosures."[12] The

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[8] SEC Release No. 33-9862, File No. S7-13-15 (July 1, 2015), p. 24.
[9] SEC Release No. 33-10064, File No. S7-06-16 (Apr. 13, 2016).
[10] Reproposal, p. 35.
[11] *Id*.
[12] *Id*.

Reproposal makes clear that the auditors are bound by this obligation, stating, "management's decision about whether to disclose additional information does not affect the auditor's responsibility 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."[13] As a result, auditors are potentially required to disclose original information about the issuer related to two elements of the critical audit matter process. The PCAOB justifies its decision to retain this disclosure requirement by concluding that the benefits of providing additional disclosure to investors are always greater than the issuer's interest in preserving confidentiality. The Reproposal thus ignores the potential harm to an issuer that may result from this original disclosure of issuer information by failing to consider the differing levels of commercial sensitivity against the relative importance of the additional information to investors (a determination, as we point out above, for the Commission and not the PCAOB to make).

In instances where an auditor would be required to provide original disclosure of issuer information, the Reproposal suggests management would have the opportunity to choose to address such disclosure[14] by authoring separate disclosure that would, presumably, permit management control over the tone and presentation of the matter. Providing an opportunity for management to author disclosure does not solve the issue of the auditor driving disclosure in the absence of any federal securities law or Commission requirement that the issuer provide such disclosure. If the audit committee or management chooses to disclose the information, it is doing so to restore control over disclosure, not because the audit committee or management believes the disclosure is required under existing securities laws or Commission regulations or otherwise is important as a matter of investor relations. That is no "choice" at all.

One of the rebuttals to criticism regarding undermining the audit committee or management is that "the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for a company's disclosure of financial information," noting that "communicating critical audit matters is not a substitute for [disclosure]."[15] However, this argument fails to acknowledge that when auditors drive the decision-making regarding the threshold decision about what is appropriate disclosure for an issuer, the auditor necessarily diminishes the governance role of both the audit committee and management in this respect.

B. The Requirement to Disclose Critical Audit Matters, as Reproposed, Will Chill Auditor Communications with the Audit Committee and Management.

As described in greater detail above, the proposed auditor reporting standard potentially requires the auditor to disclose original information about an issuer that management has affirmatively chosen not to disclose and is not otherwise required to be disclosed under the federal securities laws or Commission regulations. Any requirement that risks interfering with open and robust communications between audit committees and management, on the one hand, and auditors, on the other, undermines the relationship between issuers and auditors and, ultimately, the safeguards to investors provided by the important gatekeeping role played by the

[13] Reproposal, p. 36.
[14] Reproposal, p. 35.
[15] Reproposal, p. 35.

auditor. Maximizing the openness of communications between audit committees and management, on the one hand, and auditors, on the other, is far more likely to produce better financial reporting than the questionable benefits of additional disclosure provided by the Reproposal.

The Reproposal acknowledged the risk in the 2013 Release that communications between the auditors and the audit committee could be chilled. As a result, in an attempt to mitigate the risk, the Reproposal limits potential critical audit matter topics to those matters that are the subject of "auditor communication requirements under [Auditing Standard] 1301, other PCAOB rules and standards, applicable law… and communications made to the audit committee that were not required."[16] Thus, the Reproposal states that "any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee" and argues that, because Auditing Standard 1301 is so broad, "there should be few communications affected by that possibility."[17]

However, this effort at mitigating the risk of chilled communications ignores the reality that a willingness to engage in candid discussion can be affected by the realization that it could form the basis for a conclusion regarding a critical audit matter and disclosed accordingly. Put another way, the concern we have about chilling communication is *not* so much about how often the audit committee and the auditors will engage but what will be said when they do.

We would also note that chilled communication is by no means entirely a speculative risk. The Reproposal acknowledges that, in a study of audit committee behavior, study participants assuming the role of management chose to be less forthcoming with information when they were aware that auditors could use the information as the basis for a critical audit matter.[18]

III. Suggested Improvements to the Reproposal.

Despite our concerns, we reiterate that we welcome the PCAOB's commitment to improving the usefulness of the auditor's report to investors and believe in improving transparency between issuers and investors in a balanced fashion that considers the interests of both constituencies. We agree with the PCAOB that there is a salutary purpose in requiring auditors to identify critical audit matters to arm investors and analysts with information needed to "engage management with targeted questions about critical audit matters,"[19] which the PCAOB believes may "also lead to an incremental increase in audit quality of information presented in financial statements and related disclosures."[20]

That result can be accomplished, however, without requiring auditors to explain why they identified those matters as critical audit matters or how they addressed them in the audit. Limiting the incremental requirement to identifying critical audit matters will meaningfully address our two principal concerns – leaving disclosure judgments about issuer

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[16] Reproposal, p. 18.
[17] Reproposal, p. 19.
[18] Reproposal, p. 87.
[19] Reproposal, p. 2.
[20] Reproposal, p. 3.

information to management and audit committees, consistent of course with Commission disclosure requirements, and preserving open communication between them and the auditors. Equally important, it will serve not only to highlight issues for investors and analysts to explore with management, but will also serve as an effective check by the auditors on management's response to the Commission's requirement that companies disclose in the management disclosure and analysis section of annual and quarterly reports critical accounting estimates and assumptions that "may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance,"[21] a standard that, in many ways, is similar to the standard for critical audit matter disclosure under the Reproposal.

In formulating our proposal, we considered eliminating the requirement to describe why auditors identified matters as critical audit matters but not how they addressed them in the audit. Although the risks of forcing disclosure not required by the Commission – for example, whether a matter was deemed a critical audit matter because of the control environment (short of a material weakness) or the uncertainty over a litigation matter not ultimately deemed to require disclosure under Regulation S-K 103 or ASC 450 – and the chilling of communication are more clearly present in the "why" requirement than the "how" requirement, we ultimately concluded that the latter should be dropped as well for a number of reasons. First, we expect this description of audit procedures to become boilerplate both to limit auditor liability and to reduce audit costs and management time in discussing the description with the auditors. Second, while the two principal concerns we have expressed regarding the Reproposal are more clearly eliminated or mitigated by striking the "why" requirement, there would remain uncertainty regarding the content of the description of audit procedures to address critical audit matters that may lead to unwanted disclosure and the concomitant chill on communication we fear. Finally, we believe the judgment regarding whether the incremental disclosures of audit steps to address critical audit matters provide sufficiently useful information for investors so as to outweigh the costs to issuers of forcing disclosure of issuer information not otherwise required by the Commission or the federal securities laws is, as we have noted, one for the Commission and not the PCAOB to make. Should the PCAOB continue to conclude that the disclosure of how auditors address critical audit matters is warranted, we urge the PCAOB to permit that requirement to be limited insofar as it would otherwise require disclosure of issuer information that has not been made publicly available by the issuer.

By implementing our proposed version of critical audit matter disclosure, the PCAOB can achieve the objective of reducing asymmetries in information between management, on the one hand, and analysts and investors, on the other, while deferring to the Commission's role as overseer of issuer disclosure and maintaining open and robust communication between the audit committee and management, on the one hand, and the auditors, on the other.

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[21] SEC Release No. 33-8350 (Dec. 29, 2003).

IV. Critical Audit Matter Disclosure and the Pass/Fail Nature of the Current Auditor's Report.

Much has been said in the course of this standard-setting process about "undermining" the pass/fail nature of the current auditor's report and whether and how such undermining can be avoided. In fact, the negative implications of the reproposed new critical audit matters disclosure will necessarily and unavoidably weaken, or undermine, the standalone pass/fail nature of the current auditor's report. Indeed, we venture to say that, while in the Reproposal the Board has gone to considerable lengths to seek to ensure that the critical audit matter communications do not affect the standalone opinion on the financial statements taken as a whole, both the Board and the proponents of critical audit matters disclosure are willingly trading away the apparent certainty of the standalone existing formulation for the elaboration of the critical audit matter disclosure, with the expectation or at least hope that the elaboration of the critical audit matter disclosure will, when taken together with the pass-fail opinion, provide a more useful aggregate communication. We are also prepared to be hopeful, but we believe there is some risk that once the new reports begin to appear, the focus will be on superficial distinctions (five critical audit matters vs. three; four additional audit steps rather than two) that are not necessarily meaningful differences. We believe our suggestions above will have the salutary effect of focusing attention on what the critical audit matters are and possibly (if constrained as we have proposed) how they are addressed and therefore will lead to more focused and useful reports.

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We thank you for the opportunity to submit this comment letter. Please do not hesitate to contact Leslie N. Silverman, Nicolas Grabar or Sandra L. Flow (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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