



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

December 11, 2013

RE: PCAOB Rulemaking Docket Matter No. 034, *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*

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board’s (“PCAOB” or “Board”) proposed new auditing standards, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (“proposed auditor reporting standard”) and *The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor’s Report* (“proposed other information standard”), and related amendments to PCAOB standards (“proposed amendments”), collectively “the proposals.”

The proposals represent the culmination of several years’ work by the Board that has taken place in the context of a global re-examination of the auditor’s reporting model. While the Board affirms the value of the pass/fail model, the objective of the proposals is to increase the informational value of the auditor’s report by including information specific to the particular audit.

We support changes to the auditor’s report, and the auditor’s responsibilities regarding other information, that will be responsive to the feedback provided by users while maintaining or improving audit quality. We believe there is much in the Board’s proposals that has merit, and we commend the Board in making this significant step forward. At the same time, the fundamental changes included in the proposals pose significant challenges. We offer herein our suggestions to achieve the intended outcomes and help reduce any unintended consequences as the Board moves to the next phase of this project.

In that regard, we are pleased that the Board intends to hold a public roundtable in 2014 to discuss the proposals and the comments received from various stakeholders. We are in the process of conducting field testing to evaluate the benefits and challenges of certain aspects of the proposals, including whether application of the framework to identify and communicate critical audit matters can be executed in a consistent manner; practical issues that may arise; unintended consequences that may occur; and the audit effort and costs required in executing the proposals. We hope to share any relevant information from our field testing as the Board continues to evaluate the feedback on the proposals.

We believe that the determination and communication of critical audit matters and enhanced responsibilities related to other information will increase audit effort, and therefore costs. Perhaps more importantly, this audit effort will primarily occur late in the audit process when remaining open issues are being resolved and final reviews and analyses are occurring. This raises potential ramifications for the quality of audits and financial reporting, in addition to the monetary costs. We believe our field testing will



help us to identify and better understand these issues. However, we recommend the Board conduct a robust cost/benefit analysis of the proposals, including both the potential impact on audit quality and whether there is sufficient demand for the proposed changes to justify the incremental costs. This is not to imply change should not occur, but rather that appropriate changes be made to help reduce the potential unintended consequences of the proposals.

We have evaluated the proposals by applying the overarching principles that we developed in responding to the PCAOB's 2011 *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("concept release") which are summarized below.

- Changes made to auditor reporting should:
 - maintain or improve audit quality
 - enhance the value of the audit to users
 - increase the reliability of information the entity provides in public reports
- Changes should maintain or enhance the effectiveness of the relationships and interactions of auditors, audit committees and management in the financial reporting process
- Auditor reporting should be sufficiently comparable
- Auditor reporting can provide greater insight based on the audit, but the auditor should not be the original source of factual data or information about the entity

We have organized our recommendations into the following topical areas:

- Critical audit matters
- Other information
- Auditor tenure
- Legal considerations related to the proposals

Finally, we have included other specific comments on the proposals in the Appendix to this letter.

Critical audit matters

Overview

One of the most significant proposed changes is the introduction of a new section in the auditor's report describing critical audit matters. We commend the PCAOB for moving away from the Auditor's Discussion and Analysis alternative in the concept release and for instead developing the critical audit matter concept. We support including critical audit matters in the auditor's report and believe that they will enhance the report's informational value. Deciding which matters should be considered for inclusion as critical audit matters and the auditor's related reporting responsibilities are essential to getting this new model right. In accord with the principles outlined above, we believe that critical audit matters should be the most important matters that, in the auditor's judgment, would be relevant to users' understanding of the financial statements.

We are pleased that there is a high degree of consistency between the critical audit matter proposal and the International Auditing and Assurance Standards Board ("IAASB") proposal related to key audit



matters included in its exposure draft, *Reporting on Audited Financial Statements* (“IAASB proposal”). In our view there is room for further convergence and we encourage the PCAOB to work with the IAASB in this regard, as different models would be confusing to users. We also believe there are other areas in which convergence would be beneficial, which we discuss throughout our response.

We believe that there are unintended consequences to implementing the requirements as currently proposed, most importantly for audit quality, but also in terms of unnecessary costs. As acknowledged in question 27 on page 46 of Appendix 5 of the release (Q27), the proposed auditor reporting standard would require auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards. This is in conflict with one of our fundamental principles that the auditor should not be the original source of factual data or information about the entity, a principle which has broad acceptance by various stakeholders. As explained further below, we believe that diverging from this principle is likely to have a negative impact on audit quality.

We believe our recommendations below, including requiring that critical audit matters be material to the financial statements, strike an appropriate balance and will result in the communication of critical audit matters that provide meaningful information while limiting the unintended consequences.

Unintended consequences related to determining critical audit matters as proposed

Critical audit matters are defined in paragraph A2 of the proposed auditor reporting standard as “those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.”

The proposed definition of critical audit matters is anchored to the audit, rather than the financial statements. As a result, this will likely require the auditor to communicate original information about the entity. This will blur the line between an entity’s disclosure and auditor reporting, which is a fundamental distinction in our view, and has the potential to chill the dialogue between auditors and management. As discussed on pages 16 and 17 of the release, some commenters on the concept release were similarly concerned that it is the entity’s or the audit committee’s responsibility, not the auditor’s, to provide information, including any analysis, about the entity’s financial statements to financial statement users. We understand that the Board believes the proposed reporting of critical audit matters would address this concern because the auditor would be reporting information about the audit, based on audit procedures the auditor performed. However, anchoring the critical audit matters to the audit rather than to the financial statements will result in instances in which a matter addressed in the audit will meet the definition of a critical audit matter, but management will not have a related disclosure requirement. This will cause the auditor to have to cross the line from reporting to disclosure and communicate previously undisclosed information about the entity. As mentioned in Q27, examples of this could include a possible illegal act or resolved disagreements with management. Another example not discussed in the release is specific concerns related to fraud risk. The unintended consequences of each of these is discussed below.

- **Possible illegal acts:** Section 10A of the Securities Exchange Act of 1934 establishes protocols for auditors to communicate potential illegal acts, including fraud, to the appropriate level of management and the audit committee and to escalate the matter when timely and appropriate



remedial action is not taken. We believe including such matters in the auditor's report would undermine the proper functioning of these established processes. It may also not be in the public interest for the auditor to publicly report it because the alleged illegal act may ultimately be found to be inconsequential or have no basis in fact; therefore, it was not disclosed. If, however, it is determined that disclosure by the entity is required under the federal securities laws or the applicable financial reporting framework, the matter would most likely meet the definition of a critical audit matter and reporting by the auditor would be appropriate.

- Resolved disagreements with management: An effective, quality audit depends upon open dialogue among management, the audit committee, and auditors. In the early years after adoption of Section 404 of the Sarbanes-Oxley Act, there were concerns that entities could no longer ask their auditors about accounting and internal control matters before they were resolved because such consultation might be viewed as making the auditor part of the entity's internal controls, or that the matter discussed might automatically be deemed to be a control deficiency that would need to be evaluated from that perspective. Requiring the auditor to report publicly on resolved disagreements with management has the potential to bring back these concerns and negatively impact open dialogue. If management is deterred from engaging in early discussions with the auditor due to concerns that a change in viewpoint might be interpreted as being a disagreement between auditors and management that lack of open and frank dialogue can diminish audit quality.¹ We believe that in many situations, the issue subject to discussion would likely be reported as a critical audit matter and provide meaningful information to users. However, characterizing the discussion as a resolved disagreement can have unintended consequences for audit quality.
- Specific concerns related to fraud risk: As part of the auditor's annual risk assessment, the auditor is required to identify factors that may be indicative of a fraud risk and to plan and perform an appropriate audit response. Auditors may identify a fraud risk based upon limited information because they want to perform additional testing to evaluate whether a fraud is occurring. Due to the sensitivity of these risks, they are typically discussed only with senior level executives and/or the audit committee to avoid compromising the audit. Because fraud risks may involve the most difficult, subjective or complex auditor judgments, they would appear to meet the proposed definition of a critical audit matter regardless of whether a fraud actually occurred. We believe communicating such a matter in the auditor's report would have a negative impact on audit quality because it would reveal where the auditor is considering the risks of fraud, which will make the detection of fraud more difficult. Auditor reporting of fraud risks might also be misinterpreted by users to imply that a fraud has occurred and/or that the fraud materially impacts the entity's financial statements, when in fact there would be no basis for such a conclusion.

¹ Although there is currently a requirement for companies to publicly disclose disagreements with their auditors, it applies only in the limited context of changing auditors as opposed to an on-going auditor engagement. Separately, the auditor is also required to communicate disagreements with management to audit committees, but that circumstance is also different because it includes the opportunity for input by management and promotes the kind of open dialogue which leads to a quality audit.



Recommendations to improve the framework for determining critical audit matters

We believe the unintended consequences discussed above can largely be avoided if critical audit matters are required to be matters that are material to the financial statements.

Specifically, we recommend that critical audit matters be those “significant audit matters” (see below for further explanation) that, in the auditor’s judgment,

- (1) Were material to the financial statements,
- (2) Involved the most challenging, subjective, or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to the auditor in forming an opinion on the financial statements, and
- (3) Resulted in the most significant interaction (in terms of nature or extent) with the audit committee.

The factors described in (2) are consistent with the definition in paragraph A2 of the proposed auditor reporting standard, except that we propose changing “difficult” to “challenging” because we believe “difficult” has negative overtones that suggest critical audit matters are necessarily problematic. We are recommending that (3) be included because we believe that the matters involving the most significant interaction with the audit committee are those which would be most relevant to users’ understanding of the financial statements.

Before the auditor determines the critical audit matters, we believe the auditor should first identify the significant audit matters. The significant audit matters could be defined as matters that are both significant to the audit of the financial statements and that were required to be communicated to the audit committee (we discuss this further below). We believe that the auditor’s identification of significant audit matters in the first instance will assist the auditor in determining which are critical audit matters. In identifying significant audit matters, the auditor should take into account the factors identified in paragraph 9 of the proposed auditor reporting standard. The auditor would then apply the above framework to determine which of them meets the definition of critical audit matters. We discuss below the sources from which significant audit matters should be selected.

Determining critical audit matters in accordance with our recommendations will in most cases naturally overlap with the Board’s proposed definition of critical audit matters and the illustrative examples in Appendix 5, all of which make reference to management’s related disclosures in the financial statements. Explicitly requiring that critical audit matters be material to the financial statements will also promote consistency in their identification, thereby resulting in more comparable reporting across entities. Finally, we also believe this will result in reporting that is most useful to users’ understanding of the financial statements. This is because critical audit matters will be providing information about the most important financial statement matters the auditor addressed in the current year, including, for example, the more subjective areas in the financial statements involving significant management judgments. Reporting the most important financial statement matters as critical audit matters is consistent with the preliminary views of engagement teams across our network when considering the criteria for the selection of key audit matters to form our response to the IAASB proposal.



The “Recommendations for improving the reporting of critical audit matters” section below discusses what can be communicated in a critical audit matter, which goes beyond the emphasis of matter paragraph approach described in the concept release.

Sources from which significant audit matters are selected

Paragraph 8 of the proposed auditor reporting standard states that critical audit matters “ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three.”

We believe that matters required to be communicated to the audit committee should be the sole source of potential significant audit matters (and therefore the source of all critical audit matters).

The auditor will have already considered matters in the engagement completion document or reviewed by the engagement quality reviewer in determining the matters to communicate to the audit committee. If a matter is not important enough to require communication to the audit committee, it seems very unlikely that it will be important enough to merit reporting as a critical audit matter. Furthermore, the possibility that the auditor may be required to include information in the audit report that is not required to be communicated to the audit committee appears to be taking a step backwards from the enhanced dialogue that has occurred with audit committees in recent years and that will continue under Auditing Standard No. 16, *Communications with Audit Committees*.

Therefore, we recommend deleting the references in the proposed auditor reporting standard to matters required to be documented in the engagement completion document or reviewed by the engagement quality reviewer as sources for potential critical audit matters, and limit the sources to matters required to be communicated to the audit committee.

Recommendations for improving the reporting of critical audit matters

Subparagraph 11(b) of the proposed auditor reporting standard requires the auditor to describe the considerations that led the auditor to determine that a matter is a critical audit matter.

First, we believe that the auditor’s reporting of a critical audit matter can provide information into why the matter was important from an audit perspective by describing the principal considerations that led the auditor to conclude that the matter was a critical audit matter and a brief description of its effect on the audit. We recommend revising paragraph 11(b) to require that it is only the *principal* considerations that should be communicated in the auditor’s report. As it relates to which considerations are communicated, we believe that requiring the auditor to communicate each factor identified from paragraph 9 that is relevant to the auditor’s determination of the critical audit matter, as is done in the illustrative examples of critical audit matters in Appendix 5, would encourage a checklist approach that will lead to boilerplate language and diminish the communicative value of the critical audit matters. Furthermore, some of these factors require disclosure of original information about the entity, therefore raising the same concerns discussed above.

As it relates to the effect on the audit, we believe this would be a high level summary of how the auditor addressed the principal considerations that led the auditor to conclude that the matter was a critical audit



matter. Similar to the Board's illustrative examples, the effects on the audit may include aspects of the financial statement line item which resulted in the most challenge to the auditor (*e.g.*, the significant assumptions in an estimate, and a brief description of how the auditor responded). However, we question whether statements about the extent of specialized skill or knowledge to address the matter, or the nature of consultations outside the engagement team regarding the matter, would be useful. These considerations in many instances are required by an audit firm's policies and methodologies rather than by existing standards and thus will lack comparability across audit reports.

Second, we recommend that paragraph 11 be clear that the auditor should not disclose information about the entity that is not required to be disclosed by management. As stated above, paragraph 9 of the proposed auditor reporting standard identifies eight factors that the auditor should take into account in determining whether a matter is a critical audit matter. Although we believe these factors are appropriate for assisting the auditor in identifying significant audit matters, certain of them, if communicated in the auditor's report when describing the considerations that led the auditor to determine that the matter is a critical audit matter, would result in the communication of original information about the entity, thus raising the same concerns about blurring the line between an entity's disclosure and auditor reporting. Severity of control deficiencies and corrected and accumulated uncorrected misstatements are examples of such information. For instance, the illustrative critical audit matter disclosure in the auditor's report pursuant to Hypothetical Auditing Scenario #3 on pages 77-78 of Appendix 5 shows the auditor reporting a control deficiency less severe than a material weakness. We do not believe it is appropriate to communicate in the auditor's report information about the entity that the entity itself is not required to disclose. This would give such information undue prominence and may serve to create confusion among users about the materiality of those matters. It may also inappropriately call into question the quality of management's disclosures, especially given that the auditor reports only on an annual basis. Communication by the auditor at the end of the period may call into question the adequacy of management's interim disclosures even though there is no requirement for management to disclose the information.

Third, we agree with the proposed auditor reporting standard in not requiring that individual conclusions about the critical audit matters be included in the auditor's report, as users may inappropriately infer from such a conclusion that a separate opinion is being expressed or additional assurance is being obtained with respect to the critical audit matter. For purposes of clarification, however, we recommend that paragraph 11 include an explicit requirement that the auditor's communication of a critical audit matter not convey that the auditor is providing a separate opinion or conclusion on a critical audit matter.

Finally, paragraph 12 of the proposed auditor reporting standard describes standardized language that should precede the discussion of the individual critical audit matters communicated in the auditor's report. Consistent with our recommendations above, we believe this should also include language:

- Conforming the reporting to the recommended definition of critical audit matters described above
- Stating that the audit included performing procedures designed to address the risks of material misstatement associated with the critical audit matters; such procedures were designed in the context of the audit of the consolidated financial statements, taken as a whole, and do not express an opinion on individual accounts or disclosures
- Stating that the communication of critical audit matters is not intended to identify all matters considered to be significant to the audit



- Stating that the auditor discussed other matters with the audit committee during the course of the audit that are not being reported as critical audit matters

Documentation of critical audit matters

Paragraph 14 of the proposed auditor reporting standard includes a requirement that the auditor document the basis for the auditor's determination that "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters." We believe this requirement should not be included in the proposed auditor reporting standard because it would present implementation challenges. If the auditor identifies a matter that "would appear to meet the definition of a critical audit matter," then the auditor should communicate it as a critical audit matter. If this requirement is retained, we believe the proposed auditor reporting standard should provide more guidance on how it is to be applied. We also believe our recommendation of first identifying significant audit matters and then critical audit matters will assist in meeting the documentation requirement for the auditor to document the basis for the auditor's determination of critical audit matters.

Cost/benefit considerations

Additional coordination among management, the audit committee, and the auditor will be required to address critical audit matters included in the auditor's report. Although critical audit matters will be identified from matters that are already required to be documented, there will be incremental costs in analyzing and documenting which matters should be reported as critical audit matters, drafting communications about critical audit matters, and consulting with the national office when questions arise about the wording of critical audit matter reporting. These costs should not be underestimated. Communicating with audit committees and management with regard to the selection and reporting of critical audit matters will involve their time as well as the auditor's time. In addition to these recurring costs, there will be significant initial costs in educating and training auditors to execute on the new standard. As noted above, much of this work will occur at the end of the audit when remaining open issues are being resolved and final reviews and analyses are occurring. This timing may also have a negative effect on audit quality. We anticipate that our field testing will provide some insight to the potential costs and impact on audit quality, but we also recommend that the Board perform a robust cost/benefit analysis on these significant changes to the auditor's report.

Considerations related to audits of specific entities

In response to question 40 on page 64 of Appendix 5, we believe that audits of brokers and dealers, investment companies, and employee stock purchases, savings, and similar plans ("benefit plans") should be exempted from being required to communicate critical audit matters in the auditor's report for the reasons discussed on pages 57-63 of Appendix 5. For example, research conducted by the Board's Office of Research and Analysis indicates that ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team. In addition, we agree with commenters that the financial statements of investment companies are less complex than operating companies' financial statements and that the limited nature of an investment company's operations entails fewer estimates and judgments. Similarly, we agree that the primary objective of the financial statements of a benefit plan is to provide information about the plan's assets, liabilities, and ability to pay benefits, and we believe the plan financial statements meet this objective without the auditor reporting critical audit matters. For these



reasons, we believe the aforementioned entities should be excluded from the scope of the requirement to communicate critical audit matters in the auditor's report.

Other information

Overview

We support the Board's intent to enhance the existing standard by requiring communication about the nature of the auditor's responsibility in the auditor's report. As currently drafted, however, we believe the proposed other information standard will increase rather than decrease the expectation gap by requiring language in the auditor's report that is ambiguous and susceptible to widely varying interpretation by users. In addition, we believe the proposed other information standard will result in a significant increase in audit effort, particularly with respect to information not directly related to the audited financial statements (i.e., "nonfinancial information"), with a corresponding significant increase in costs that in our view will exceed the benefits. Our recommendation above that the Board conduct a robust cost/benefit analysis of the proposals is of particular importance with respect to the proposed other information standard should the Board move forward with it as currently proposed.

We believe the changes we suggest below will (i) align the nature of the audit effort with the auditor's responsibilities, in particular by differentiating the work performed on material other information directly related to the audited financial statements from that performed on nonfinancial information, and (2) resolve significant issues with respect to the communication in the auditor's report of the auditor's responsibilities related to other information.

Expectation gap

In our comment letter on the concept release, we stated that "describing the procedures performed by the auditor on information outside of the financial statements would clarify the auditor's responsibility with respect to such information, and help reduce the expectation gap by addressing the misperception that the auditor's opinion covers such information."

We believe the reporting in the proposed other information standard, however, may serve to increase rather than decrease the expectation gap. Notwithstanding the disclaimer of opinion, we are concerned that the language "we evaluated" is ambiguous and could be read to mean that the auditor is expressing an opinion on the other information or performing audit-type procedures. The term "evaluate" is more commonly associated with the auditor's responsibility in an audit to determine whether the evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report. This is the context in which "evaluate" is used in Auditing Standard No. 14, *Evaluating Audit Results* and, more recently, in Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements (AS 17)*, which states on page 12 of Appendix 3 that "the evaluation should encompass, among other things, whether the information: is complete and accurate, is consistent with the audited financial statements, and complies with relevant regulatory requirements, if applicable." As a result, to evaluate typically includes consideration of completeness, which if applicable here would significantly change the auditor's responsibility and audit effort; this task is better placed with respect to other information as the responsibility of the entity and its securities counsel. If the Board retains "evaluate" either a separate examination engagement under the attestation standards should be



considered or the proposed other information standard should explain specifically what is expected of the auditor in this context, including with respect to documentation.

We are also concerned that the statement in the report that “our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit” is ambiguous and suggests that the audit effort with respect to other information is more extensive than the proposed procedures, particularly with respect to nonfinancial information. For instance, users may erroneously infer that the auditor obtained audit evidence and reached conclusions on all nonfinancial information. In addition, saying audit “evidence obtained” and “conclusions reached during the audit” seems to indicate that the nonfinancial information was subject to audit procedures. In reality the opposite is true, as the nonfinancial information is not in the scope of the audit. As indicated in the release and further discussed below, such information may coincidentally be gathered by the auditor during the course of risk assessment and other planning procedures, but this differs significantly from information subject to audit procedures. This may lead to an “over reliance” on the auditor’s proposed statement that he or she has not identified a material inconsistency or material misstatement of fact. This issue may be exacerbated as companies expand the amount of nonfinancial information not directly related to the financial statements they disclose. For example, the Sustainability Accounting Standards Board has encouraged companies to consider disclosing sustainability topics within MD&A of the Form 10-K.

In order to mitigate the expectation gap, we believe the language in the auditor’s report should clearly communicate the auditor’s responsibilities by describing the nature of the procedures the auditor is required to perform, as further discussed below.

Cost/benefit considerations

We are concerned that the audit evidence obtained that is referred to in the proposed other information standard seems to include *all* information gathered during an audit, not just the information subject to audit procedures. Without making these distinctions, we believe the proposed other information standard typically would require the auditor to first search the audit file to determine whether information was gathered during the audit, and if so, to perform procedures in an effort to determine whether a material inconsistency or material misstatement of fact exists if the information in the audit file does not agree to management’s disclosure, and finally, to document the findings from this exercise. We believe this will be a costly exercise that far exceeds the benefits.

For example, on page 13 of Appendix 6, the Board discusses how management might state in the other information that the entity has the largest market share in the entity’s industry. In this example, the auditor may or may not have obtained information during the audit indicating whether management’s statement is a material misstatement of fact. More importantly, the example suggests that the auditor would need to do a search of the audit file for nonfinancial information to determine whether there is something in the file about this issue regardless if it was subject to audit procedures. If the information is included in the audit file, then the auditor would need to consider whether it reconciles to the entity’s filing. Searching for the information in the audit file and then determining whether there is a material misstatement of fact in the other information would involve significant audit effort with little obvious value to users as the information to which it is being compared was not subject to audit procedures. In addition, it will be difficult for the auditor to determine whether the other information truly contains a material misstatement of fact because the comparable information in the audit file (1) is not subject to audit procedures and (2) may have been gathered early in the audit and is no longer current.



Consistent with existing standards and with paragraph 5 of the proposed other information standard, we agree that if the auditor becomes aware of a potential material misstatement of fact in the other information, the auditor should discuss the matter with management and perform additional procedures, as necessary, to determine whether there is a material misstatement of fact. Our concern rather relates to the question of what audit effort should be required in searching for a potential material misstatement of fact in nonfinancial information. We believe our recommendations below with respect to nonfinancial information strike an appropriate balance from a cost/benefit perspective. If the Board believes there is value for the auditor to perform procedures on nonfinancial information, then a separate attestation engagement with separate reporting should be considered.

Auditor's procedures

Our recommendation is to replace the proposed "read and evaluate" proposal with one that is in our view more likely to result in consistent execution and more efficient in terms of the value provided for the audit effort involved. Specifically, we believe the proposed other information standard should include an overall requirement that the auditor read *all* of the other information (see below for comments related to scope), regardless of whether the other information is directly related to the audited financial statements. The auditor should then perform a prescriptive set of procedures, based in part on PCAOB AU 634, *Letters for Underwriters and Certain Other Requesting Parties*, with respect to material other information directly related to the audited financial statements, including qualitative statements.

The procedures to be performed on material other information directly related to the audited financial statements would compare the material other information to (1) the financial statements or (2) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information. In addition, we agree that the auditor could recalculate the amounts in the other information when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula as described in paragraph 4(d) of the proposed other information standard. However, we believe these procedures should be performed only on "material" other information directly related to the audited financial statements, as some other information directly related to the financial statements is not material when considered in the context of other information compared to the materiality of the financial statements. We believe that limiting these procedures to material other information directly related to the audited financial statements will reduce costs but maintain the benefits.

For other information not directly related to the audited financial statements, we believe the auditor's responsibility should continue to be consistent with that in PCAOB AU 550, *Other Information in Documents Containing Audited Financial Statements*. That responsibility is to read the other information and, if the auditor becomes aware of a potential material misstatement of fact in the other information, based on knowledge gained in the course of conducting the audit, to respond appropriately.

Auditor's reporting

We recommend replacing the report language in paragraphs 13 and 14 of the proposed other information standard with language that explicitly describes the limited procedures the auditor performed, as described below, and therefore will more clearly communicate the auditor's responsibility with respect to



other information. In addition, we believe the statements in paragraph 13(e) of the proposed other information standard that the auditor has or has not identified a material inconsistency, a material misstatement of fact, or both should be replaced with a statement of our responsibility to report such matters in the audit report if they have not been appropriately revised. As discussed below, we believe that including a statement of fact describing our responsibility instead of stating a conclusion at a point in time will (1) help mitigate the practical challenges related to the timing of when information becomes available, (2) still provide relevant information about what would occur if the auditor becomes aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both that is not resolved; and (3) eliminate the ambiguity in the report language currently proposed. We would also note that the proposed changes would also help to mitigate some of the increased litigation risks associated with the proposed other information standard.

Specifically, we believe the report should include the following:

- A statement that the auditor is required to read the other information and, with respect to material other information directly related to the audited financial statements, perform limited procedures including comparing the material other information directly related to the audited financial statements to (1) the financial statements or (2) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information
- A statement that these limited procedures do not constitute an audit or review of the other information
- A statement that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact in the other information or both, that has not been appropriately revised, the auditor is required to describe the misstatement or inconsistency in the audit report

Timing issues

Under the proposed other information standard the auditor would not generally be responsible for information incorporated by reference that is not available to the auditor prior to the issuance of the auditor's report. However, the proposed other information standard would apply to information incorporated by reference in a Form 10-K from the entity's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.

The information in the definitive proxy statement is not subject to the original reporting requirement, but the proposed other information standard would require the auditor to apply PCAOB AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU 561). However, AU 561 is based on information the auditor has already reported on and was not meant to apply procedures to information that is planned to be received subsequent to issuance of the auditor's report. Therefore, it appears the proposed other information standard arguably has in essence established "prospective" reporting on information that is not available at the time of report issuance, which is not feasible. At the very least this would likely create confusion as to what information is in or out of the scope of the auditor's report. We believe that describing the auditor's responsibilities instead of stating a conclusion at a point in time will help mitigate some of these concerns.



If the proposed other information standard continues to require a conclusion, we believe it should either exclude the proxy from scope or provide guidance on how the auditor should report with respect to the proxy when it is available to the auditor at a date later than when the 10-K is filed. We also believe the Board should provide guidance on how the auditor should report in situations in which the audited financial statements with the auditor's report thereon are issued prior to the 10-K filing, and therefore prior to the availability of most, if not all, of the other information that is within the scope of the standard. For example, some entities first complete an annual report to shareholders before the 10-K is filed and other companies file audited financial statements on a separate 8-K at the time of their earnings release. Also, for investment companies the Form N-CSR is not required to be filed until ten business days after the financial statements are transmitted to shareholders. In these circumstances, we believe this could be confusing to users because what is being reported on is dependent on when the entity issues its audited financial statements and, in the example of audited financial statements issued at the same time as the earnings release, there may be no other information, or very little other information, available to the auditor. The reporting on other information in this example would be inconsistent with most other entities purely as a result of the timing of issuance of the audited financial statements.

As stated above, we believe that describing the auditor's responsibilities instead of stating a conclusion will help mitigate these concerns. If the proposed other information standard continues to require a conclusion, we believe it should also address these practical considerations as part of a final standard.

Scope

The scope of the proposed other information standard includes all the exhibits listed in an entity's annual report except for XBRL. We believe the scope should be limited to exhibits that are directly related to the audited financial statements, that is, information from the accounting records subject to the audit, or which has been derived directly from such accounting records (e.g. ratio of earnings to fixed charges). Other exhibits, such as material contracts, would continue to be evaluated for purposes of the audit as deemed necessary. For example, the auditor would read a material contract during the audit to determine whether its terms were being accounted for appropriately in the financial statements. If the contract is included as an exhibit in the annual report, it would seem unnecessary for the auditor to further evaluate it for purposes of determining whether there is a material inconsistency or a material misstatement of fact as the proposed other information standard would require. We also question what would constitute a material misstatement of fact for the many exhibits that are executed contracts or final documents or what the material inconsistency with the financial statements might be when its terms were already considered in evaluating whether the accounting was appropriate. We believe our recommendation to limit the scope to exhibits that are directly related to the audited financial statements helps mitigate these concerns.

In addition, we agree with the Board's statement on page 9 of Appendix 6 that "Audited financial statements of an entity other than the company ... may be required to be included in the company's annual report. The Board does not intend for the other entity's financial statements to be considered other information in the company's annual report, under the proposed other information standard, because they are not the company's financial statements and were already subject to a separate audit." We further believe that the company's annual report should not be considered other information from the perspective of the auditor of other entity, and that this is the Board's intent as page 9 of Appendix 6 also states, "The proposed other information standard would apply to the other information in the annual report of the company that is making the filing." We recommend that this point be clarified.



Documentation

We believe the proposed other information standard should provide guidance on the nature and extent of required documentation. Our recommendations above to limit the auditor's incremental procedures to material other information directly related to the audited financial statements should reduce the audit effort compared to what is currently proposed. Nonetheless, it still represents greater involvement by the auditor regarding other information than is required under existing standards, and we believe documentation guidance would be appropriate. If the proposed other information standard is finalized as it is currently proposed, we believe it is even more essential that documentation guidance be provided, as determining and documenting whether all other information is part of the audit file and then documenting consideration of each statement would be a significant increase in audit effort for what appears to be of limited value.

Considerations related to audits of brokers and dealers

In response to question 28 on page 45 of Appendix 6, we do not support the application of the proposed other information standard to audits of brokers and dealers because we believe the SEC's recently adopted amendments to Rule 17a-5 provide users of brokers' and dealers' financial statements with sufficient information that makes additional auditor reporting unnecessary. Furthermore, the PCAOB recently adopted attestation standards that address the auditor's examination of compliance reports and the auditor's review of exemption reports which, together with AS 17, provide sufficient auditor involvement in reporting of brokers and dealers.

Auditor tenure

Paragraph 6(i) of the proposed auditor reporting standard requires the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the entity's auditor. As noted on page 16 of Appendix 5, the Board has not reached a conclusion related to a relationship between audit quality and auditor tenure. We believe that including auditor tenure in the audit report would create the false impression that such a relationship exists and would give undue prominence to this information. Moreover, the responsibility for hiring and dismissing the auditor rests with the audit committee, not the auditor. Accordingly, we do not believe that auditor tenure should be included in the audit report. However, if audit committees and management believe it is useful information given their specific facts and circumstances, we would not object to disclosure by them of tenure elsewhere. This would allow for the disclosure to be provided in the proper context related to oversight of the auditor.

Legal considerations related to the proposals

The release asks what effect the proposals would have on an auditor's potential liability in private litigation. We believe there will be a significant increase in litigation risk for the profession.

First, the proposed auditor reporting standard greatly expands the number and variety of statements which will be attributed to the auditor and under applicable federal securities laws, an entity can only be subject to suit relating to statements that are made by and properly attributed to it. The additional statements will thus greatly expand the possibilities for plaintiffs' lawyers to allege auditor misconduct, irrespective of the merit of such allegations. Second, the proposed other information standard use of the



word “evaluate” is problematic given how it is used in other auditing contexts as described above, and will encourage claims that the auditor should have identified omissions in the other information, regardless of the merits of those claims. This goes well beyond what we believe the Board intended and blurs significantly the line between the roles of the auditor and those of the issuer’s securities counsel. Third, the additional statements regarding critical audit matters will allow plaintiffs to parrot and mischaracterize those statements to create an incorrect appearance of specificity as required to plead scienter and survive dismissal. Finally, if these cases are not dismissed at the outset, the enormous litigation and particularly discovery costs often drive a settlement regardless of merit. The proposals will likely mean more spurious claims will be brought, fewer meritless cases will be properly dismissed at an appropriate stage, and more unwarranted settlements will need to be reached.

The changes we have proposed help mitigate some of these risks, primarily by grounding the auditor’s statement in a concept of materiality, by not blurring the lines of responsibility for reporting of original information about the entity related to critical audit matters, and by describing the auditor’s responsibilities instead of providing a conclusion related to other information. However, even with these changes, the incremental liability risk to the auditing profession is expected to be significant.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Michael J. Gallagher (646-471-6331) or Marc Panucci (973-236-4885) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP



APPENDIX

This appendix provides additional comments on specific requirements in the proposals for the Board's consideration.

Basic report elements

Descriptions of the auditor's responsibilities and the nature of an audit

Overall, we support proposed changes to enhance the description in the auditor's report of the auditor's responsibilities with respect to the notes to the financial statements; material misstatement, whether due to error or fraud; and independence. We also support proposed changes to better align the description of the nature of an audit with the Board's risk assessment standards.

In addition, we continue to encourage the PCAOB to work with other standard setters, in particular the IAASB, to eliminate unnecessary differences in describing the auditor's responsibilities and the nature of an audit in the auditor's report. The auditor's responsibilities and the nature of an audit are generally the same regardless of the auditing standards being followed; therefore, having different descriptions runs the risk of confusing rather than informing users of the financial statements.

Addressees of the audit report

Paragraph 6 of the proposed auditor reporting standard identifies the basic elements that must be included in the auditor's report. Subparagraph 6(b) states that the auditor's report must include "addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body." Footnote 8 related to this subparagraph states that, "For example, addressees might include other appropriate parties depending on the legal and governance structure of the company," and page 9 of Appendix 5 identifies bondholders as an example of such "other appropriate parties."

The proposed auditor reporting standard does not provide sufficient guidance on what investor other than a shareholder should be an addressee and in which circumstances an auditor would be required to address its report to bondholders, and we cannot think of any.

There could also be legal risk in expanding the required addressees. As a practical matter auditors may already include "shareholders" as an addressee of the auditor's report. Indeed, we do this in recognition of the fact that shareholders are frequently users of financial statements, and so support the report being addressed to the shareholders and the Board of Directors or equivalent body. However, we do not do this out of any obligation and this practice does not reflect the auditor's legal duty of care which runs solely to the client. While the law differs from state-to-state, as a general matter where courts have found exceptions, it is because the plaintiff has been able to show that the auditor has exhibited its intent to accept an expanded duty of care through its conduct.

A standard which creates requirements in terms of the addressee of the auditor's opinion could cause courts incorrectly to hesitate in properly applying the privity rule and risk improperly expanding the auditor's duty of care based merely on the report's addressees.



Opining on the schedules to the financial statements

Subparagraph 6(d) requires that the auditor's report must include "a statement identifying each financial statement and related schedule, if applicable, that has been audited" and related footnote 9 states that "various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited." Pages 10-11 of Appendix 5 also state that "the proposed auditor reporting standard would require specific references to the related notes and, if applicable, schedules because those are identified as part of the financial statements pursuant to SEC Rule 1-01(b) of Regulation S-X."

We agree with the above requirements identifying SEC-required schedules as part of the financial statements covered by our opinion. However, paragraph A(4) in the General Instructions to Form 10-K provides that ". . . all schedules required by Article 12 of Regulation S-X may, at the option of the registrant, be filed as an amendment to the report not later than 30 days after the applicable due date of the report."

We ask that the proposed auditor reporting standard clarify that when a registrant files the schedules pursuant to the instructions above or other situations when the schedules are finalized separately from the financial statements, auditors may, consistent with current practice, issue a separate report.

Basis of opinion

Paragraphs 6(j)-6(n) identify the required statements that comprise the Basis of Opinion section of the auditor's report. We believe that subparagraphs (m)(1) and (m)(2) should be combined into a single subparagraph as shown below to be more consistent with the presentation in the illustrative report on pages 15-16 of Appendix 1 (proposed additions are in ***boldface italics***; deletions are in ~~strike through~~):

- m. A statement that an audit includes:
 - (1) 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, appropriate evidence regarding the amounts and disclosures in the financial statements***
 - ~~(2) Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements~~

Ordering of the basic elements of the auditor's report

We support the statements in footnotes 12, 21 and 24 of the proposed auditor reporting standard that require explanatory paragraphs, if any, to follow the Opinion on the Financial Statements section of the auditor's report, unless otherwise required by other PCAOB standards; the Critical Audit Matters section to follow the Opinion on the Financial Statements section and any explanatory paragraphs; and the Auditor's Responsibilities Regarding Other Information section to follow the Opinion on the Financial Statements section, any explanatory paragraphs, and the Critical Audit Matters section. We also support the requirements in paragraphs 21 and 59 of the proposed amendments to PCAOB AU 508, retitled *Departures from Unqualified Opinions and Other Reporting Circumstances* (AU 508), that the



paragraph(s) describing the reasons for a qualified or an adverse opinion, respectively, should precede the opinion paragraph in the Opinion on the Financial Statements section of the auditor's report. We do not believe any further specific order for the presentation of the auditor's report should be required.

We do, however, believe the proposed auditor reporting standard and related amendments should require the use of section titles throughout the report, not just for the Critical Audit Matters and Auditor's Responsibilities Regarding Other Information sections of the report, as we believe section titles will help users in reading the report and bring some consistency to the format of the audit report. The section titles in the illustrative report on pages 15-16 of Appendix 1 are a good start but could be another area where convergence with the IAASB may be helpful.

Explanatory language in the auditor's report

We support including in the proposed auditor reporting standard a description of the circumstances in the PCAOB's auditing standards that would require explanatory language or an explanatory paragraph along with references to the relevant PCAOB standards that establish such requirements. We believe that keeping this information in a single place facilitates consistency in execution.

We also support retaining the auditor's ability to add a discretionary explanatory paragraph (an "emphasis of a matter" paragraph in extant AU 508) to emphasize a matter regarding the financial statements in circumstances when the matter does not meet the definition of a critical audit matter. Paragraph 16 of the proposed auditor reporting standard identifies examples of matters, among others, that the auditor may choose to emphasize in the auditor's report. We believe that items (a) "significant transactions with related parties" and (e) "an uncertainty relating to the future outcome of significant litigation or regulatory actions" should be removed from the list because we believe these two items are more likely to be determined by the auditor to be critical audit matters.

We do not, however, support the discussion on pages 47 and 49 of Appendix 5 stating that a matter that is the subject of an explanatory paragraph, whether required or discretionary, might also be communicated as a critical audit matter. We believe discussing the same matter both in an explanatory paragraph and in the Critical Audit Matter section of the report could be confusing to users and, accordingly, we do not support that practice. We believe the auditor should determine whether the subject matter of the explanatory paragraph meets the definition of a critical audit matter and if so, limit the discussion to the Critical Audit Matter section of the auditor's report. If the matter does not meet the definition of a critical audit matter, then it should be included in an explanatory paragraph. See below for further details related to modified opinions.

Amendments to other PCAOB standards

We appreciate that the PCAOB has proposed amendments to its standards by marking its existing standards to show the additions and deletions. This facilitates reviewing the amendments and we encourage the Board to continue this practice going forward.

Proposed new paragraph 58A of AU 508 would require an auditor's report expressing an adverse opinion to include The Auditor's Responsibilities Regarding Other Information (other information) section of the auditor's report. If the proposed other information standard continues to require a conclusion statement related to other information, we do not believe this conclusion should be required when an adverse



opinion is expressed. We agree with the statement on page 55 of Appendix 5 that “the most important matter to investors and other financial statement users would be the reason for the adverse opinion;” in such circumstances, we believe the other information section should be omitted because its inclusion may overshadow the importance of the matter(s) giving rise to the adverse opinion.

A proposed new note to paragraph 21 of AU 508 states, “The auditor would refer to Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter.” We believe that a matter giving rise to a qualification of the opinion is a critical audit matter and the proposed note should be revised to be consistent with that position. Furthermore, we do not believe it is clear from the proposed amendments to AU 508 whether the Board would expect the reason for the qualification to be discussed both in the “basis for departure from an unqualified opinion” paragraph(s) which, along with the opinion paragraph, comprise the Opinion on the Financial Statements section of the report, and also in the Critical Audit Matters section of the report. We believe, as stated above, that discussing the same matter in two different sections of the auditor’s report would be confusing and should not be required. We believe the discussion of a matter giving rise to a qualified opinion should be discussed in the “basis for departure from an unqualified opinion” paragraph(s) in the Opinion on the Financial Statements section of the report. A cross reference should also be made from the Critical Audit Matter section to the Opinion on the Financial Statements section of the report, such as the following example which is adapted from the IAASB’s proposal: “In addition to the matter described in the Opinion on the Financial Statements section of our report, we have determined the matters described below to be critical audit matters.”