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Presentation in Connection with the Public Company Accounting Oversight Board Proposed Auditor's Reporting Model

Public Hearings
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Introduction

I would like to thank the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") and its staff for the opportunity they have provided this afternoon to participate in the Board's public hearings on April 2 and 3, 2014 regarding its August 2013 proposal to enhance the auditor's reporting model.[1]

I am a partner in the New York office of Cleary Gottlieb, whose practice includes significant focus on advising clients in complex disclosure matters, especially financial disclosure, and in the legal aspects of accounting and auditing issues. I regularly participate in the preparation of financial disclosure and regularly review and use financial statements and other financial disclosure in my work. This work includes the following: advising issuers on their reporting obligations (including financial disclosures); advising issuers and underwriters in connection with a wide variety of capital markets transactions; and advising various parties in the context of a variety of different corporate transactions. Financial reporting, including its reliability and relevance, is often a critical element of these matters, and my firm's involvement requires us to be intimately familiar with (and, frequently, closely involved in) the financial reporting process.

I also served as Director of the Division of Corporation Finance of the Securities and Exchange Commission and as Senior Counselor to the Commission from January 2002 through February 2006, during the time that started shortly after Enron's filing for bankruptcy and wended its way through a number of other accounting and financial and reporting scandals, including WorldCom. That period also saw the enactment and implementation of, and rulemaking under, the Sarbanes-Oxley Act of 2002.

I subsequently served as a member of and counsel to the Co-Chairs of the Treasury Department's Advisory Committee on the Accounting Profession (sometimes referred to as the ACAP), in 2007 and 2008. The ACAP's Final Report was issued in October 2008.[2] Finally, I am a member of the Board of Directors and Audit Committee of a public company.

My observations today are based on the knowledge and perspectives that I have gained from these experiences. I am of course speaking this afternoon only for myself and not for any current or past affiliations.

[1] PCAOB Release No. 2013-005 (August 13, 2013) (the "Proposing Release").
[2] ACAP Final Report (October 6, 2008) (the "ACAP Final Report").

The announced purpose of the public hearings is to address the Board's proposals to enhance the auditor's reporting model set out in the Proposing Release. In a broader context, this public meeting is an important step in what has been and will I believe continue to be an important Board project and process – considering changes to the audit report on financial statements, which has remained largely unchanged for decades. I support the Board's initiative in this area, which the ACAP recommended. The process and timeline of the Board is summarized below. The major focus of these efforts has been to ascertain whether the existing auditor reporting model, including in particular the central "pass-fail" feature, meets the needs of today's investors, other users of financial statements and markets; and also otherwise adequately takes into account the interests of other stakeholders in the financial reporting and auditing process (including the management and audit committees of preparers and the auditors).

The Board's process and timeline for its initiative regarding the auditor's reporting model have included the following:

- There have been three years of outreach to interested stakeholders and the issuance of a Concept Release in June 2011,[3] which sought public comment on a number of possible approaches to modifying the auditor reporting model.

- The 2011 Release was followed by a roundtable regarding the possible approaches set forth in the 2011 Release, as well as other possible approaches, held by the Board on September 15, 2011 (in which I was one of many participants).

- The Board then issued the Proposing Release, which sought further public comment on the specific proposals contained therein, in August 2013.

- The Board has now convened the two days of public hearings on April 2 and 3, 2014.

History and Background

The last fundamental evolution in the financial reporting model ironically involved moving away from more of a "free-writing" model to a model with standardized language. According to the 2011 Release and the sources cited therein,[4] the change to a form of required wording developed starting in the 1930s, and the Securities and Exchange Commission (the "Commission") weighed in with required wording in a December 1940 release.[5] As the 2011 Release puts it, the auditor's report has evolved into an expression of an opinion "as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable accounting framework."[6] The objective of what has become referred to as the standardized "pass-fail" model was to provide comparability and to make it easier to identify qualifications and exceptions in an audit report.

[3] PCAOB Release No. 2011-003 (June 21, 2011) (the "2011 Release").
[4] 2011 Release, Appendix A, p. A-1.
[5] Accounting Series Rel. No. 21; Securities Act Rel. No. 33-2460 (December 5, 1940).
[6] 2011 Release, p. 3.

While the "pass-fail" model has been preserved with only minor changes for many decades and, as discussed below, has served investors and markets very well, there has (at least since the 1970s) also been a discussion or debate as to whether more significant change to the reporting model is appropriate. I believe the discussion or debate has focused on two general topics.

First, a number of commentators over the years, including both the National Commission on Fraudulent Financial Reporting (the "Treadway Commission") in 1987[7] and the ACAP in its Final Report in 2008, focused on what has come to be called an "expectations gap" between, on the one hand, the perceptions of investors and other users of financial statements and audit reports regarding the responsibilities of auditors and, on the other hand, the actual responsibilities of auditors and the limitations of the audit process (or the perception of the auditing profession as to those responsibilities and limitations).

According to the ACAP, the Treadway Commission "recommended that the standard auditor's report more clearly identify the auditor's responsibilities, the degree to which users can rely on the audit, and the limitations on the audit process."[8] The ACAP Final Report goes on to say, "The Treadway Commission aimed to reaffirm that management has 'primary responsibility for financial statements' and to caution users of financial statements from placing more than 'reasonable' assurance on the audit process."[9] One result of this focus was the development of a new paragraph for the standard audit report, sometimes known as the "scope paragraph," which describes the responsibilities of management and the auditor and states whether the auditor has obtained sufficient evidence to provide a reasonable basis for its opinion.

The expectations gap has nonetheless persisted, particularly in respect of the detection by auditors of fraud. The ACAP specifically considered testimony and commentary regarding the expectations gap "between the public's expectations regarding auditor responsibility for fraud detection and the auditor's required and capable performance of fraud detection." The ACAP's recommendations regarding this continuing situation included:

- More effective communication by auditors of their responsibility regarding fraud detection to investors and the capital markets.[10] "Accordingly, the Committee believes that the auditor's report should articulate clearly to investors the auditor's role and limitations in detecting fraud. The Committee believes that expressly communicating to investors, other financial statement users and the public the role of auditors in finding and reporting fraud would help narrow the expectations gap."

- Clarification by the Board and the Commission in the auditor's report of the auditor's role and limitations in detecting fraud under current auditing standards.

- Review by the Board of the auditing standards that govern fraud detection and fraud reporting.

[7] Report of the National Commission on Fraudulent Reporting (October 1987).
[8] ACAP Final Report, p. VII:15.
[9] Id., p. VII:16.
[10] Id., p. VII:18.

Second, beyond the expectations gap, there has been significant attention devoted to consideration of other potential improvements to the auditor's report. In particular, the Commission on Auditors' Responsibilities (the so-called Cohen Commission) was established by the American Institute of Certified Public Accountants (the "AICPA") in 1978 to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish." The ACAP Final Report stated that the Cohen Commission's recommendations "called for an expansion of the auditor's report to include a report not merely on the financial statements, but covering the entire audit function. The Cohen Commission reasoned that this new more comprehensive information would benefit users, but also clarify the role and, consequently, the legal standing of the auditor in relation to the audit. (footnotes omitted)."[11]

After considering the testimony and commentary it had received regarding the auditor's report, the ACAP Final Report recommended that the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model.[12] The Final Report of the ACAP provided, in relevant part,

> "The Committee has also heard testimony regarding expanding the auditor's report. One witness noted that some institutional investors believe that an expanded auditor's report would enhance investor confidence in financial reporting and recommended exploring a more 'narrative' report in areas, such as 'estimates, judgments, sufficiency of evidence and uncertainties.'"
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> "The Committee notes that the increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting. The Committee believes this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements. While there is not yet agreement as to precisely what additional information is sought and would be useful to investors and other users of financial statements, the Committee concludes that an improved auditor's report would likely lead to more relevant information for users of financial statements and would clarify the role of the auditor in the financial statement audit."[13]

<u>The Current Proposals</u>

For several years the Board has been embarked, as summarized above, on the standard-setting initiative that the ACAP recommended.

While, as noted above, there is and has been a broader project and process regarding the auditor reporting model, the current public hearings in which we are participating

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[11] <u>Id.</u>
[12] <u>Id.</u>, p. VII:17.
[13] <u>Id.</u> With respect to that last point, the ACAP Final Report also observes, "The PCAOB should also take cognizance of the proposal's potential legal ramifications, if any, to auditors." <u>Id.</u>, p. VII:18.

are focused principally on the Board's two proposed auditing standards set out in the Proposing Release. The proposed standards are, first, a standard addressing the auditor's report on an audit of financial statements (the "proposed auditor reporting standard"), which would modify the content and format of the existing auditor's report and would, in particular, require the auditor to provide information with respect to both "critical audit matters" and its evaluation of "other information"; and second, a standard addressing the auditor's responsibilities regarding "other information" in certain documents that contain audited financial statements (the "proposed other information standard"), which sets out the auditor's responsibilities with respect to a review and evaluation of such other information.

Guiding Principles

In evaluating the proposed new standards and the resulting changes to the auditor's reporting model, as well as the broader context of the project, I am entirely dedicated to the full and fair disclosure – including, in particular, financial disclosure and reporting – called for by the federal securities laws, transparency to investors and markets, and the improvements in financial disclosure and reporting that are fostered by the application of robust auditing standards by independent external auditors. I also acknowledge the investment community's concern, clearly identified by the Board in both the 2011 Release and the Proposing Release, that auditors may possess information that is useful to investors and other financial statement users that is not communicated in the existing auditor's report. I therefore would support changes to the auditor's report that improve financial reporting or investors' and other users' understanding of financial reporting.

I have further attempted to apply the following guiding principles, which I believe would further these key objectives.

- First, the audit is a means to achieve an end. Any change to the auditor's role or report should therefore help achieve that end, namely improving an issuer's financial reporting or investors' understanding of that financial reporting;

- Second, while the Board is seeking to enhance the value of the auditor's report, the importance of the current pass/fail model should not be underestimated, and any changes to the auditor's report should not undermine the pass/fail model;

- Third, any new standard should be designed to reduce the expectations gap and should certainly not have the unintended consequence of exacerbating it;

- Fourth, if there is additional original information regarding an issuer that should be disclosed, that disclosure should be the responsibility of, and should come from, the issuer, and should not come from the auditor or any other third party;

- Fifth, any additional information sought to be obtained from auditors in a revised auditor's report should be carefully calibrated to focus on matters actually within the professional expertise, judgment and experience of auditors;

- Sixth, any change to the auditor's reporting model should not have the unintended consequence of adversely impacting the relationship and structure of interactions among management, the audit committee and auditors as they have developed since the enactment of the Sarbanes-Oxley Act of 2002 and the related implementation of regulations and standards adopted by the Commission and the Board; and

- Seventh, the benefits of any path pursued by the Board should outweigh the costs. The proposals focus on changes to the auditor's report and not to standards related to the conduct of an audit. Additional work and procedures required to comply with additional report requirements should be minimized and identified and evaluated as part of consideration of any proposals.

While I favor changes to the auditor reporting model that lead to improved financial reporting or increase investors' understanding, I am concerned the proposed auditor reporting standards, while representing an improvement from certain of the possible approaches discussed in the 2011 Release, continue in several important respects not to further those objectives and to depart from these principles.

Summary of Concerns with the Proposals

As discussed in more detail below, I believe the proposed standard relating to disclosure of critical audit matters ("CAMs") will not improve financial reporting or investors' understanding for a number of reasons, including the following:

- As the standard is proposed, and as CAMs are currently defined in the proposal, the disclosure will not in many cases be likely to convey meaningful information regarding financial reporting or its quality;

- The proposed standard regarding CAMs will necessarily undermine the value of the pass-fail element of the auditor's report;

- It is certain that the current proposal will either require preparers to include information in their disclosure regarding CAMs that the preparers would otherwise not be required to disclose under Commission rules or lead to audit reports that contain original information regarding issuers being published by the auditors; and

- The proposed standard raises significant risks of adversely impacting the relationship between audit committees and external auditors.

The proposed other information standard – which goes significantly beyond the audit standard currently applicable to information outside the financial statements and notes thereto – also raises concerns for a number of reasons, including the following:

- There is no persuasive indication that the proposed standard will lead to better financial reporting than, or advantage investors, other users or markets over, the current standard.

- The scope of the information to which the proposed standard will apply is overly broad in that it will require auditors to "evaluate" information and make judgments as to inconsistency, inaccuracy and materiality that are outside their expertise;

- The scope of the work called for in the proposed standard not only extends beyond the auditor's expertise but also is ambiguous and not capable of evaluation by investors;

- The standard by its terms calls for more work (with questionable benefits), and the uncertainty of the boundaries of the work will result in even more work; and

- Because investors will find it very difficult to determine what new information they are receiving or what importance to ascribe to it, any benefits will thus be uncertain, and this uncertainty could itself lead to an undesirable increase in the expectations gap.

Alternative Approach for Consideration – Auditor Focus on Critical Accounting Policies and Estimates

Before addressing in more detail the concerns summarized above regarding the proposed new CAM standard, I would like to revisit a proposal that was already made in Cleary Gottlieb's comment letters on the 2011 Release and on the Proposing Release.[14] I believe this proposal ameliorates those concerns and, at the same time, could provide more useful information to investors and other users regarding financial information and financial reporting than the proposed CAM standard in particular. I would respectfully suggest that the PCAOB might consider modifying its approach and implement a revised standard and a supplemental statement in the auditor's report regarding an issuer's disclosures relating to critical accounting policies and estimates.

Disclosure by issuers of critical accounting policies and estimates in their MD&A is now almost universal. Nonetheless, as referenced in my firm's earlier comment letters, I believe enhancing disclosure by issuers of the impact of accounting estimates and judgments on their financial statements and reporting may be desirable. Each issuer's financial reporting framework includes a significant number of estimates that can produce significant uncertainty, require significant judgment (by preparers and auditors) and could cause results to vary significantly.[15] It has sometimes been suggested during the discussions regarding the Board's

[14] Comment Letter on 2011 Release by Cleary Gottlieb Steen & Hamilton LLP (October 14, 2011), available at http://pcaobus.org/Rules/Rulemaking/Docket034/149_Cleary_Gottlieb.pdf and Comment Letter on Proposing Release by Cleary Gottlieb Steen & Hamilton LLP (December 23, 2013), available at http://pcaobus.org/Rules/Rulemaking/Docket034/231b_CGSH.pdf.

[15] The Commission's guidance to date in this area includes the following: two releases discussing critical accounting policies in December 2001 (SEC Rel. No. 33-8040; 34-45149 (Dec. 2001)) (the "2001 Guidance") and

CAM proposals that the substantive question at hand is, "What keeps the auditor or the engagement partner awake at night?" I would submit that, for a preparer with a properly crafted section on critical accounting policies and estimates, that section is generally a pretty good list of what keeps the auditor awake. I would also submit that, in such a case, a CAM that covers an accounting matter not included in that section may well not be included on the auditor's "it keeps me awake" list. So we should not approach the issue of what is important to financial reporting and its quality, or what increases investor understanding of significant matters, by indirection—let us instead address it directly.

In the 2001 Guidance, the Commission suggested that issuers should disclose in the MD&A the "accounting policies that management believes are most 'critical' – that is, they are both most important to the portrayal of the company's financial condition and results, and they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain."[16] The Commission noted that both the issuer's management and its auditor should "bring particular focus" to evaluating the critical accounting policies. Subsequently, in the 2003 Guidance, the Commission also focused on materiality, noting that issuers should disclose in their MD&A "accounting estimates or assumptions where the nature of the estimates or assumptions is 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 the impact of the estimates and assumptions on financial condition or operating performance is material."[17] In addition, as the Commission separately noted in its 2002 Rule Proposal, an issuer's auditor is already responsible for evaluating the reasonableness of the accounting estimates made by management in the context of the financial statements taken as a whole.[18] Indeed, my experience makes clear to me that an auditor already has significant involvement in these disclosures.

I believe the adoption of a standard provision for focused attention by the auditor on an issuer's critical account policies and estimates disclosure could improve issuer disclosure and provide greater understanding to investors. It should also satisfy some of investors' expressed concerns because it will result in auditors communicating what they have learned about critical aspects of a preparer's financial reporting <u>in precisely the core area of auditor</u>

January 2002 (SEC Rel. No. 33-8056; 34-45321 (Jan. 2002)) and guidance on critical accounting policy disclosure in its December 2003 interpretive release on MD&A (SEC Rel. No. 33-8350; 34-48960 (Dec. 2003)) (the "<u>2003 Guidance</u>"). The Commission also proposed rules on critical accounting policies in May 2002, but has not adopted them. SEC Rel. No. 33-8098; 34-45907 (May 2002) (the "<u>2002 Rule Proposal</u>").

[16] 2001 Guidance, p. 2.

[17] 2003 Guidance, p. 18. The Commission further suggested in the 2003 Guidance that factors issuers might choose to address in this disclosure could include how management arrived at the estimate, how accurate the estimate/assumption had been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future, but noted that these factors should analyzed "to the extent material." <u>Id.</u>

[18] <u>See</u> 2002 Rule Proposal, pp. 26-27. <u>See also</u> AU Section 342, *Auditing Accounting Estimates*, paragraph 4 ("<u>AU 342</u>"). In making that evaluation, the auditor must obtain evidence sufficient to provide reasonable assurance that all accounting estimates that could be material to the financial statements have been developed, that those estimates are reasonable in the circumstances and that those estimates are presented in conformity with applicable accounting principles and are properly disclosed. AU 342, paragraph 7. In the 2002 Rule Proposal, the Commission also indicated it was considering whether to adopt a requirement that an independent auditor must examine, in accordance with attestation standards, the MD&A disclosure relating to critical accounting estimates. The Commission has not adopted the 2002 Rule Proposal.

expertise, accounting policies and estimates. The auditor could, for example, be asked to provide negative assurance in its audit report that, based on its work on and evidence compiled during the audit, nothing has come to its attention that causes it to believe (a) the disclosure included in the document that contains financial statements that were subject to the audit fails to address all critical accounting estimates or policies that are required to be disclosed, or (b) the disclosure regarding critical accounting estimates or policies included in the document is not accurate in all material respects. A different auditing standard and a different statement could also be considered.

This approach would, in my view, represent a significant improvement over the standards proposed by the Board in the Proposing Release. It would have the benefit of addressing matters that are material to an issuer's financial reporting generally, not to the audit specifically. In addition, it would avoid any requirement that the auditor be a source of original disclosure about the issuer, as the auditor would be commenting on issuer disclosure and would not be making additional disclosure (assuming that the issuer makes modifications that the auditor identifies as necessary under disclosure requirements and standards of materiality). It also would be less likely to call into question the pass/fail model, as it does not raise any concern about audit judgments. Finally, it requires the auditor to evaluate only accounting matters, rather than other matters that may be beyond the scope of the auditor's expertise, which means it should be both meaningful and cost-effective to implement.

I appreciate that the Board would like to act expeditiously to provide enhancements to the auditor reporting model. I believe that, in light of the existing Commission guidance regarding critical accounting policies and estimates, the Board could design standards and reporting models in this area. If my supposition turns out to be incorrect, and either the Board or the Commission or both conclude that it would also be necessary for the Commission to provide additional interpretive guidance or engage in rulemaking, then joint action would be preferable, in my view, to proceeding with the CAM standard. The most important advance towards higher quality financial reporting and auditing in recent times has taken place over the last decade-plus, with the enactment of Section 404 of the Sarbanes-Oxley Act, regarding internal control over financial reporting, and the Commission's rulemaking and the Board's standard-setting thereunder. While that road has had some bumps, I believe it ended well, and if joint action turns out to be necessary, I believe it will still get investors and other users, as well as other stakeholders, to a better place than the current Board CAM proposal.

Discussion of Concerns with the Current Proposed CAM Standards

A. The Proposed CAM Auditing Standard Would Require Disclosure of Matters That Are Not Material.

In the Proposing Release, the Board stated that describing considerations around a critical audit matter could require the auditor to disclose "information about the audit or the financial statements that otherwise would not be required to be disclosed by either the auditor or the company under existing auditor reporting standards or requirements of the applicable financial reporting framework."[19] This result would be unfortunate. It would result in required

[19] Appendix 5 of the Proposing Release, p. A5-42.

disclosure by auditors (rather than issuers) not simply of information about issuers, but of information about issuers that may be neither material nor required, and that therefore should not be required to be disclosed under a PCAOB standard.

I am concerned that, as specifically contemplated by the Proposing Release, the additional disclosures an auditor would be making may not be material. Issues relating to "new" disclosures being made by the auditor will unavoidably arise insofar as the proposed auditor reporting standard requires the communication in the revised auditor's report of "critical audit matters." As stated in the Proposing Release's proposed definition of critical audit matters, that disclosure would focus on the matters the auditor addressed during the relevant audit which involved the most difficult, subjective or complex auditor judgments, or posed the greatest difficulty to the auditor in obtaining sufficient appropriate evidence or in forming its opinion on the financial statements.[20]

But the importance or materiality of an audit matter to the issuer's financial statements is not specified as a factor in determining whether an audit matter is critical. Indeed, most of the factors specified for consideration in the proposal relate to matters having to do with the audit process, rather than matters related to the significance of the impact of the audit matter on the financial statements.[21] As a result, matters may be determined to be critical audit matters that are not material – and may not even be particularly meaningful – to the financial reporting or other financial disclosure of the issuer. Indeed, there will be nothing in the CAM presentation under the proposal that will provide investors with any guidance that will assist in distinguishing whether a critical audit matter is, in fact, material to an issuer's financial reporting or otherwise material from the issuer's standpoint.[22]

Two modifications would ameliorate this consequence of the proposal. First, the standard should explicitly require in the standard for identifying critical audit matters that the auditor consider the materiality of the impact of the audit matter on the issuer's financial statements and other financial disclosure, and conclude the audit matter relates to material elements of that disclosure, in order to be a critical audit matter. Second, the filter for selecting CAMs should require that the matter rise to the level of discussion with the audit committees. Such changes would not, however, address the broader point regarding auditor disclosure of original information about issuers.

B. The Proposal Would Cause Significant Expansion of Existing Disclosure Regarding Issuers By Auditors.

[20] Paragraph 9 of the proposed auditor reporting standard sets out a non-exclusive list of factors the auditor would need to take into account when determining whether a matter is a critical audit matter.

[21] For example, the proposed factors include the degree of subjectivity involved in determining or applying audit procedures, the nature and extent of audit effort required and the nature and amount of available relevant and reliable evidence, as well as matters such as the extent of specialized skills needed to apply audit procedures and the nature of consultations outside the audit engagement team. Release, p. A1-7.

[22] We believe it likely that, under the proposed standard, even if a critical audit matter addresses immaterial aspects of financial reporting, both issuers and auditors will prefer the auditor not be the sole source of the information disclosed in the auditor's report, which in many cases may lead issuers to revise their disclosures to include a discussion of any matter identified as a critical audit matter, regardless of materiality.

One of the greatest concerns with the proposed CAM standard is that, as proposed, it would require the auditor to be the source of a significant amount of additional original information about an issuer. Under the existing auditor reporting model, original disclosures by an auditor generally occur only if an issuer has not complied with accounting principles or disclosure requirements.[23] Any change to the auditor reporting model should, I believe, keep the responsibility for disclosure about an issuer where it belongs, i.e., with the issuer.[24]

By contrast, the proposed CAM standard would necessarily lead, and indeed seems intended to cause, auditors to be responsible – either indirectly by causing the issuer to make additional disclosures, or directly through the auditor's report – for a significant amount of original disclosure. Indeed, the limited field testing described in the comment letter dated December 11, 2013, submitted by Deloitte & Touche LLP to the Board,[25] states that 18% of the CAMs identified in the field tests were not included in the preparer's existing disclosures. An auditing standard where one-in-five cases produces disclosure by auditors about issuers that is not otherwise required under the Federal securities laws, including the Commission's regulations (or would effectively force issuers to make these disclosures), clearly runs afoul of a basic principle that disclosure about issuers is the responsibility of issuers.

This unfortunate result is not an unintended consequence but instead is a necessary result of the proposed CAM audit reporting standard. The Proposing Release states explicitly – and illustrates, including via PCAOB-prepared sample disclosure – that an auditor may be required to make new disclosures beyond those mandated under the current financial reporting framework, including disclosures that apparently run contrary to current regulatory intent. I believe this would be an unfortunate and inappropriate result.

In Hypothetical Auditing Scenario #3,[26] the issuer has experienced a control deficiency less severe than a material weakness. The sample disclosure of the critical audit matter explicitly references that deficiency, stating that "…it was necessary [for the auditor] to expand the planned audit procedures due to a control deficiency less severe than a material weakness …. Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee."[27] The current rules of the Commission and the Board, however, do not contemplate disclosure by an issuer (or an auditor) of a significant deficiency (or any other control deficiency not rising to the level of a material weakness). In fact, when proposing to define "significant deficiency," the Commission noted that "[t]he purpose of management's obligations with respect to significant deficiencies … is to disclose those matters relating to [internal control over financial reporting ("ICFR")] that are of sufficient importance that they should be reported to the external auditor and to the audit committee so that

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[23] I believe the "going concern" qualification, which can be original information in an auditor's report, is anomalous, is currently the subject of reconsideration in order to require possible preparer disclosure on the subject, and in any event should not be viewed as the basis for wholesale inclusion of additional original information in an auditor's report.
[24] 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.
[25] Comment Letter by Deloitte & Touche LLP (December 11, 2013), available at http://pcaobus.org/Rules/Rulemaking/Docket034/132b_Deloitte.pdf.
[26] Appendix 5 of the Proposing Release, p. A5-74 *et seq.*
[27] Appendix 5 of the Proposing Release, p. A5-78.

these parties can more effectively carry out their respective responsibilities with regard to the company's financial reporting, but which do not require disclosure to investors. (*Emphasis added.*)"[28] The Commission's expressed intent under the ICFR disclosure framework is that a control deficiency that rises only to the level of a significant deficiency is not required to be disclosed in a company's public filings. That conclusion is entirely consistent with the overall tenor of the discussions around ICFR disclosure, that public disclosures be limited to material weaknesses to avoid conflating material and immaterial disclosures to investors.

The proposed auditor reporting standard would, however, apparently represent a requirement of the PCAOB that would mandate disclosure contrary to a settled disclosure policy. By going beyond the approach contained in the current requirements, this result risks the same conflating of material and immaterial matters that has heretofore appropriately been avoided. And this auditor disclosure requirement about an issuer's ICFR would be imposed even if the issuer itself had determined the disclosure was unnecessary.

Another example of what would appear to be an intended required disclosure by auditors under the CAM standard of matters regarding issuers, where the Commission's requirements for issuer disclosure run to the contrary, involves uncorrected errors. The sixth of the nine factors proposed by the Board to be considered by auditors in determining whether a matter is a CAM is "[t]he nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any." The Commission's Staff Accounting Bulletin No. 108[29] was the end point of a lengthy process of analysis as to whether, when and how a preparer is required or permitted to correct errors in its financial statements. Any "accumulated uncorrected misstatements" will only exist if SAB No. 108 permits them to be uncorrected and undisclosed. Yet the CAM standard, as I read it, could compel auditors to address those same accumulated uncorrected errors in identifying and discussing CAMs under the proposed auditor reporting standard.

A final example where the proposed disclosure of a critical audit matter could add to the mix of information about an issuer that is publicly available, but in a way that may be prejudicial to the issuer, is in the context of disclosures regarding potential loss contingencies. Under the current standard set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 450 and related FASB interpretations, a company must accrue a liability for a material loss contingency if available information indicates it is probable a loss has been incurred and the amount of the loss can be reasonably estimated. A company is required to accrue the best estimate of loss within a range of probable losses; however, if no estimate in the range is better than any other, the minimum amount of the range is required to be accrued.

[28] SEC Rel. No. 33-8811; 34-55930, p. 5 (June 20, 2007). In the related adopting release, the Commission stated that "[i]n proposing the definition, we believed that the focus of the term 'significant deficiency' should be on the communications required to take place among management, audit committees and independent auditors." SEC Rel. No. 33-8829; 34-56203, p. 9 (Sept. 10, 2007). The PCAOB's relevant Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, similarly requires the auditor to communicate any significant deficiencies identified only to the audit committee.

[29] SEC Release No. SAB 108 (September 13, 2006).

Recent proposals to update this standard were widely debated and roundly criticized for failing to adequately take into account the realities of today's litigation environment, because they required a company to disclose quantitative and qualitative information that could be highly prejudicial to its litigation posture.[30] The process of auditing loss contingencies often involves difficult, subjective or complex auditor judgments, and privilege and other concerns can pose challenges for issuers in providing evidence relating to determinations made by issuers about loss contingencies. At the same time, however, the very same problems that were raised by the recent FASB proposal would apply to the disclosures an auditor may be required to make in explaining in its auditor's report why this determination is a CAM. Indeed, the proposed auditor reporting standard will likely raise additional concerns, because it might require (or be interpreted as requiring) an auditor to describe loss contingencies for which the issuer had determined neither an accrual nor disclosure of reasonably possible loss was required.

The auditor reporting standard as proposed thus has the potential to (or appears to be intended to) require an auditor to disclose original information about an issuer, even if that information may only be relevant to the audit process and not material to the financial statements or other financial reporting of the issuer or is otherwise too prejudicial to the issuer to justify incremental disclosure.

C. Disclosure of Critical Audit Matters Will Necessarily Undermine the Pass/Fail Nature of the Current Auditor's Report.

The negative, though speculative, implications of the new CAM disclosure will necessarily undermine the pass/fail nature of the current auditor's report. I would refer you to the comment letter of Dennis Beresford, a very experienced auditor and audit committee member who makes this point powerfully.[31] Like Mr. Beresford, I am concerned the discussion of CAMs is likely to implicitly qualify the pass/fail nature of the current auditor's report, by calling into question the reliability of the information used by the auditor in forming an opinion on the financial statements. Notwithstanding the uncertainty as to what these new additional disclosures would mean, they can be expected at a minimum to convey that caution (whether warranted or not) should be applied regarding financial disclosures that were difficult to verify.

D. The Requirement to Disclose CAMs and the Other Information Standard May Adversely Impact Auditor/Audit Committee Relations.

I am acutely sensitive to the fact that investors believe auditors have information about preparers which investors want to have communicated in the auditor report. That strongly felt view is apparent in much of the record the Board has developed, and it was also apparent in the testimony and commentary obtained by the ACAP.

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[30] *See, e.g.*, FASB, Exposure Draft, Proposed Accounting Standards Update, Contingencies (Tope 450), Disclosure of Certain Loss Contingencies, File Reference No. 1840-100 (July 20, 2010), and the summary of the 339 comment letters received on the proposal published by the FASB as of October 26, 2010, both available on the FASB's website at www.fasb.org.

[31] Comment Letter by Dennis R. Beresford (October 11, 2013), available at http://pcaobus.org/Rules/Rulemaking/Docket034/006b_DBeresford.pdf.

While investors have strongly expressed a desire for more direct communication by auditors in audit reports, I believe, based on considerable experience with boards and audit committees, that more effective communications on some subjects can take place between auditors and audit committees, and that the results will accrue to investors' advantage. The Board's recently adopted Audit Standard No. 16 is an example of success in that area. Auditors will be more candid in executive session with audit committees regarding a preparer's financial reporting than they will be in their audit reports. That is simply a fact.

Adding potential disagreements about CAMs, which an auditor will disclose, could affect candor. The tension will be exacerbated when the proposed CAM standard would potentially require the auditor to disclose "new" information about an issuer that management has affirmatively chosen not to disclose and is not otherwise required to be disclosed under the securities laws or the Commission's regulations. That information may be quite sensitive. The result could interfere with open and robust communications among management, audit committees and auditors, to the detriment of the relationship between audit committees and auditors, and ultimately, potentially to the detriment of investors. Maximizing the openness of communications between management, audit committees and auditors is more likely to produce better financial reporting and disclosure than the questionable benefits of the additional disclosure provided by the proposed standard.

E. The Documentation Requirements Regarding Matters Not Identified As CAMs Will Lead to Substantial Additional Work and Expense.

The Proposing Release acknowledges that the proposed CAM standard will lead to some increased work and expense, including for documentation of CAMs, but I believe it unrealistically underestimates the consequences of requiring documentation regarding matters not selected as CAMs. Because the standards for identifying CAMs are necessarily subjective and involve judgment, in the face of the requirement, there is a significant risk that auditors will believe it necessary to document their decision in connection with a sizable array of matters. And this tendency will be exacerbated, as will the tendency to identify more CAMs than might otherwise be the case, by the not-unjustified fear that any audit failure regarding a matter not identified as a CAM will become an additional potential avenue for litigation.

Discussion of Concerns with the Proposed Other Information Standard

The proposed other information standard would require disclosure in the auditor's report of the auditor's responsibility for, and evaluation of, certain other information, defined as every bit of information in the audited document other than the audited financial statements (and certain supplemental information),[32] pursuant to the proposed other information standard. The

[32] "Other information" is defined in the Proposing Release to include information (other than the audited financial statements and the related auditor's report, but including certain specified information that is incorporated by reference) included in a company's annual report filed with the Commission under the Securities Exchange Act of 1934 (the "Exchange Act") (*i.e.*, its Form 10-K, Form 20-F or similar form). The Proposing Release notes, however, that this evaluation is based on "relevant evidence obtained and conclusions reached during the audit." Release, p.7. Accordingly, if such "other information" is not directly related to the audited financial statements, is non-financial in nature or is related to the company's operations, the auditor may not have obtained evidence or reached any conclusion regarding that information during the audit – and, accordingly, would not be required to reach any conclusion with respect to it.

proposed standard would require the auditor to expressly state both that it has evaluated the other information and whether or not it has identified in the other information any material inconsistency with the financial statements or material misstatement of fact.[33]

A. Any Requirement to "Evaluate" Other Information Beyond Financial Information Would Exceed Auditors' Expertise.

Applying the proposed other information standard with respect to information other than financial information is inconsistent with the auditor's role and core expertise. The Proposing Release notes several less obvious disclosures that could be covered in certain circumstances – such as statements about the company's competitive environment, technological developments or supplier relationships – and describes a situation where the auditor might have knowledge, based on relevant audit evidence obtained during the audit, that contrary to a company's claims it does not have the largest market share in its industry. Having an other-information standard that extends beyond financial information to, for example, operational risk or competitive considerations – even something that while critically important, like the status of pharmaceutical testing for a pharmaceutical manufacturer, is entirely outside an auditor's professional expertise – is nearly certain to bring more uncertainty than clarity and potentially even cause an increase in the expectations gap. Asking an auditor to make any "evaluation" of any of these matters, let alone every bit of non-financial information in an annual filing containing audited financial statements, goes far beyond any auditor's professional expertise. Auditor expertise centers on financial information, financial reporting, auditing and related matters, and generally does not extend to evaluating business strategy and trends, analyzing risk (other than risks regarding financial reporting) or predicting future performance. If auditors are required to evaluate, at most, specified financial information disclosed in the annual report, I believe the result would be to increase audit costs while increasing the expectations gap by appearing to provide comfort regarding consistency or accuracy that is unjustified.

B. Investors Will Have No Way to Determine What "Other Information" in an Issuer's Filings Has Been Evaluated by the Auditor.

Because the proposed standard contains a public disclosure requirement, it becomes necessary to define "other information." However, the proposed definition of "other information" is broad, vague and non-specific, and indeed has to be read, as already stated, as including every bit of information not included in the audited financial statements.[34] The precise contours of the other information the auditor is actually evaluating may be opaque to investors (apart from the obvious, *e.g.*, selected financial information, or recitals of GAAP financial data). Moreover, the information obtained by a particular auditor in conducting a particular audit, against which "other information" will be evaluated, will be entirely opaque to investors and will not be comparable among audits of different preparers and over different audit years. Due to these variables, it will be impossible for investors to determine the extent to which "other

[33] Under the proposed standard, if the auditor has identified a material inconsistency with the financial statements or a material misstatement of fact, it must discuss the issue with management and may, depending on management's response and the circumstances of the statement or inconsistency, be required to advise the audit committee; consider any obligations it may have under Section 10A of the Exchange Act; withdraw from the audit engagement; or include appropriate disclosure in its auditor's report.
[34] *See* note 26 above.

information" in an annual report has actually been evaluated, and against what it has been evaluated. The proposal thus presents a significant risk of confusion among investors as to what they are getting, and of a consequent increase in the expectations gap. Finally, the requirement to "evaluate" the entire universe of other information may well cause auditors to collect more information and undertake standards of review that tend towards an audit (thereby vitiating the only boundary principles in the standard that would avoid an explosion of work and cost).

By comparison, existing AU Section 550, *Other Information in Documents Containing Audited Financial Statements* ("AU 550"), already provides a sufficient check by the auditor on inaccurate disclosure and strikes an appropriate balance by requiring the auditor to read and "consider" the "other information" contained in issuer filings and, if it identifies concerns regarding that information, to report those concerns to management (and, if necessary, the audit committee, or, in particularly problematic cases, to consult with counsel or withdraw from the audit engagement). But AU 550 does not require the auditor to include information in its audit report, nor does it place the auditor in the role of "evaluating" (apparently a higher standard of review) non-financial information. AU 550 allows the auditor and management or the audit committee to discuss and modify disclosure of other information where necessary and thus, while it does not provide investors and other users with public disclosure, it provides essentially the same benefits. And as noted above, auditors currently have remedies where in their view disclosure is inadequate.

Having said that, if the Board nonetheless seeks to provide a standard calling for a statement regarding "other information" in the auditor report, I would recommend limiting the statements and limiting the "read and evaluate" formulation that has been suggested in the proposal to well-defined information of a financial nature, including for example the facts and figures (but not necessarily the forward-looking information) in MD&A, selected financial information and the like. With respect to consideration of non-financial "other information," I would recommend maintaining the current AU 550 approach.

The likely end result in almost every circumstance will be the same as under the current standard – if auditors have concerns about disclosure, they will discuss them with issuers, including audit committees as appropriate. Issuers, which can revise their disclosures at any time before the auditor issues its report, will make such changes, if any, as are appropriate. There is no persuasive evidence to support, and no logic to suggest, either that the existing standard puts investors, other users or markets at risk or that the proposal would lead to improvements. First, as others have noted, there is no persuasive body of evidence that errors in "other information" not corrected as a result of current AU 550 have had a material adverse impact on disclosure or have disadvantaged investors. Second, the Board itself notes that the likely outcome of the proposed other information standard would be modifications by issuers and auditors stating in their reports that no material inconsistencies or misstatements appear in the other information. AU 550 is intended to produce the same process and modifications where appropriate. Where is the persuasive evidence that the inclusion of the proposed statement in the auditor's report adds value to balance against the costs? The result will be essentially the same whether or not the auditor is required to include a statement in its reports.

The Proposed Auditing Standards Are Likely to Heighten Litigation Exposure for Both Auditors and Issuers.

I have also been asked to address the proposed new standards from a legal point of view. Both standards will cause heightened litigation exposure under the securities laws and impose the resulting costs. The proposed other information standard, in particular, will significantly increase litigation exposure by requiring auditors to affirmatively state their findings, even in cases where nothing has been found or in cases where preparers have made modifications satisfactory to the auditors as to matters the auditors have identified. As we emphasized in Cleary's comment letters, I am not merely raising the sorts of generalized concerns regarding auditor liability, or increases therein that are often raised in discussions of the role of the auditor in public company financial reporting and audits. Rather, the proposed new standards, because of the combination of additional affirmative statements by auditors, the possible applicability of the *Janus* decision discussed below and the possible implications of the proposal in respect of liability under the Securities Act of 1933 (the "Securities Act") raise specific and serious issues. Litigation risks and issues are not in themselves reasons not to adopt new standards. Indeed, they are an acceptable (and in many cases a necessary) consequence where they are the result of change that brings real benefits to investors and others. In the case of the instant proposals, however, they should be weighed against what are to my mind questionable benefits.

A. There Is a Significant Likelihood the Potential for Auditor Liability Would Increase under Anti-Fraud Provisions.

First, under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, an auditor can be liable if it makes a statement in its auditor's report that is misleading when made and the requisite scienter standard is met. The proposed audit standards require an auditor to make certain new statements in connection with their auditors' reports:

- Statements identifying and providing the required information regarding CAMs; and

- A statement as to whether or not the auditor, based on reading and evaluating specified information, has identified any material inconsistencies with the financial statements or material misstatements of fact in the other information.

The requirement under the proposed other information standard that the auditor make an affirmative statement that it has read and evaluated the other information, and as to whether or not it discovered any such inconsistencies or misstatements, seems particularly problematic, both because, as I discussed before, the scope of other information is broad – i.e., every bit of information in or incorporated into the annual reports, including information not related to financial matters – and because the proposed "evaluation" procedures increase the level of work and will likely involve a significant volume of evidence obtained by the auditor, including evidence that may or may not be related to financial statements or financial reporting. As a result, any qualitative statement relating to information as to which an auditor might have obtained evidence during the course of the audit process may become the subject of a lawsuit. And because the auditor is making an affirmative statement, under the Supreme Court's decision in *Janus*,[35] the auditor could be subject to a private right of action under Rule 10b-5 predicated

[35] *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (June 13, 2011).

on the material inaccuracy of its statement. This liability risk, sharpened by *Janus*, does not currently exist under AU 550 where statements as to other information are made only to the issuer.

Under the proposed CAM standard, the auditor would similarly be required to make a number of additional affirmative statements in its auditor's report. In particular, the auditor would be required to identify the CAMs associated with the audit and provide the information called for by the standard.[36] The disclosure (or non-disclosure) of all of these CAMs in the auditor's report could result in the kinds of affirmative statements that could result in liability under the *Janus* standard and thus could create significant opportunities for a plaintiff to bring suit against an auditor following the revelation of a misstatement or omission that, particularly in hindsight, can be alleged to have been material. If the CAM standard as proposed provides valuable information to investors, then of course that benefit must be weighed against the liability risk. As noted above, however, I have significant questions as to those benefits.

A particular litigation concern is raised by the requirement that the auditor retain audit documentation with sufficient information to enable an experienced auditor who has no previous connection with the engagement to understand the basis for the auditor's determination that each *non-reported* audit matter that would appear to meet the definition of a CAM was, in fact, not a CAM. While the Board notes several reasons why this would be useful (including enabling the PCAOB inspection staff to determine whether this aspect of the proposed new standard is being properly implemented), it also creates (and requires an auditor to retain) a detailed documentary record of the auditor's determination that a matter was <u>not</u> "critical." If this would require an auditor to retain work papers or materials beyond those that would have been separately required to document the auditor's audit determinations, it would seem to accomplish little of benefit to investors while potentially providing a "road map" with respect to any matters "identified but not determined to be critical." This provision should be reconsidered in light of the substantial risks involved.

B. As Proposed, the Standards Appear to Create at Least Some Potential for Liability under the Securities Act.

Both the proposed auditor reporting standard and the proposed other information standard appear to have the potential to increase auditors' liability exposure with respect to offerings conducted under the Securities Act. The more difficult analysis of this question, however, involves the proposed other information standard. The Proposing Release explicitly notes that, consistent with existing AU 550, that standard would not apply to documents filed with the Commission under the Securities Act, and that an auditor's responsibilities with respect to Securities Act filings are governed by its responsibilities under Section 11 of the Securities Act and AU Section 711, *Filings Under Federal Securities Statutes*.

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[36] We note the proposed auditor reporting standard would also require auditors to make affirmative statements regarding a number of other matters, including that it is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company, and the year that it began serving as the company's auditor. Because these are more focused, factual statements about matters with which the auditor is readily familiar, they do not raise a liability concern.

There are certain disclosure provisions of the Commission rules and the Board's standards that apply in the context of Exchange Act filings but do not apply to Securities Act filings. Perhaps the most apposite example involves management's evaluation of and auditors' attestation of internal control over financial reporting. Those provisions apply to annual reports filed with the Commission (for example, an annual report on Form 10-K), but not to registration statements filed under the Securities Act (for example, a registration statement on Form S-1). However, the provisions do apply to an Exchange Act annual report that is incorporated by reference into a registration statement filed under the Securities Act. So, for example, a shelf registration statement for a large accelerated filer on Form S-3 that incorporates by reference a Form 10-K would contain management's evaluation of internal control over financial reporting and the auditor's attestation, but a registration statement that does not incorporate a 10-K by reference would not. It does not seem to me that this anomaly should overly concern the Board in developing its standards.

That having been said, it does not appear that the Proposing Release addresses the implications for incremental auditor liability that arise from including the additional information required by the proposed audit standards, particularly with regard to other information, in auditors' reports that are incorporated by reference into registration statements. In particular, it is not clear whether the statements regarding CAMs would or should be viewed as statements of an "expert" under Section 11 of the Securities Act, and it is even less clear to me that the statements regarding other information, based on their limited evaluation rather than on an "audit," would or should be viewed as statements of an expert. This is currently not of concern under AU 550 because, as noted above, that standard does not require the auditor to make any statement in the auditor's report that names the auditor and is part of the registration statement. While the Board may not intend to impose expert liability on the auditor with respect to the auditor's statement regarding other information, and also may not intend to impose such liability on the identification and description of CAMs, in the absence of clear guidance by the Board and particularly by the Commission, that will not necessarily be the outcome, or the uniform outcome, if the issue were to be widely litigated. During any period of uncertainty, Section 11 litigation risk will persist. Moreover, settlement dynamics, which are particularly important in cases under Section 11, will be affected.