



Via Email

May 26, 2010

J. Gordon Seymour
General Counsel and Secretary
Public Company Accounting Oversight Board
1666 K Street
Washington, DC 20006-2803

Re: *Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards (PCAOB Rulemaking Docket No. 030)*¹

Dear Mr. Seymour:

The Council of Institutional Investors (“Council”) appreciates the opportunity to provide comments on the Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards (“Proposal”). The purpose of this letter is to express our general support for the Proposal.

The Council is an association of public, corporate, and union pension funds with combined assets of over \$3 trillion. As a leading voice for long-term patient capital, we believe that accurate and reliable audited financial statements are critical to investors in making informed investment decisions, and vital to the overall well-being of our capital markets.² We also believe that the audit committee plays an important role in ensuring the accuracy and reliability of audited financial statements.³ That role is acknowledged in the following long-standing Council policy:

Audit Committee Responsibilities Regarding Outside Auditors: The audit committee should have the responsibility to hire, oversee and, if necessary, fire the company’s outside auditor.⁴

¹ Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards 1-21 (Mar. 29, 2010), http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf [Hereinafter Proposal].

² Council of Institutional Investors, Statement on Independence of Accounting and Auditing Standard Setters (adopted Oct. 7, 2008), <http://www.cii.org/UserFiles/file/Statement%20on%20Independence%20of%20Accounting%20and%20Auditing%20Standard%20Setters.pdf>.

³ Council of Institutional Investors, Corporate Governance Policies, **§ 2.12a Audit Committee Responsibilities Regarding Outside Auditors** (updated Apr. 13, 2010), <http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%204-13-10.pdf>.

⁴ *Id.*

We agree with the view of the Public Company Accounting Oversight Board (“PCAOB”) that the audit committee may better carry out its responsibilities regarding outside auditors if it “is well-informed about accounting and disclosure matters relating to the audit”⁵ We also agree that “[o]ne way the audit committee may be informed of accounting and disclosure matters is through the communication of the auditor’s evaluations of matters that are significant to the financial statements.”⁶ Thus, we generally support the enhancements in communications between the audit committee and outside auditor as set forth in the Proposal.

There are three aspects of the Proposal that we believe would be of significant benefit to audit committees in fulfilling their oversight responsibilities. First, we strongly support the Proposal’s new requirements requiring the auditor to record the mutual understanding of the terms of the audit “in a written audit engagement letter, and to include the understanding of the objective of an audit and the responsibilities of the auditor and management.”⁷ We agree with PCAOB Acting Chairman Daniel L. Goelzer that these requirements “better align the Board’s standards with the requirements of the [Sarbanes-Oxley] Act.”⁸ We, however, would add one additional matter to the engagement letter that we believe would significantly enhance investor protection.

We would require that for any engagement letter that includes a provision that potentially limits the legal liability of the outside auditor, the letter include an explanation as to why the provision does not reduce audit quality. Such a provision would be consistent with Council policy.⁹ It would also be consistent with the views of the staff of the United States (“US”) Securities and Exchange Commission and the US federal banking agencies who generally agree that limits on auditor liability place investors at risk.¹⁰

⁵ Proposal, *supra*, at 2.

⁶ *Id.*; See, e.g., Michael R. Young, Accounting Irregularities and Financial Fraud 102 (CCH 3rd ed. 2006) (“Meaningful, substantive interaction with the outside auditor is fundamental to effective audit committee oversight of financial reporting”).

⁷ Proposal, *supra*, at 6.

⁸ Daniel L. Goelzer, Acting Chairman, PCAOB, Statement on Proposed Auditing Standard Related to Communications with Audit Committees 1 (Mar. 29, 2010), http://pcaobus.org/News/Speech/Pages/03292010_GoelzerStatement.aspx.

⁹ Council of Institutional Investors, **§ 2.12e Liability of Outside Auditors** (“Companies should not agree to limit the liability of outside auditors”).

¹⁰ See, e.g., Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Nancy M. Morris, Federal Advisory Committee Officer, Securities and Exchange Commission 13-14 (Mar. 31, 2008), [http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/March%2031,%202008%20SEC%20comment%20letter%20Progress%20Report%20_Final_\(1\).pdf](http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/March%2031,%202008%20SEC%20comment%20letter%20Progress%20Report%20_Final_(1).pdf) (Citing the SEC’s Codification of Financial Reporting Policies on indemnification by Client and an Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters).

Second, we strongly support the Proposal's new requirements for the auditor to communicate to the audit committee an overview of the audit strategy and timing.¹¹ More specifically, we support the requirement of a communication about the roles, responsibilities, and locations of firms participating in the audit.¹² This communication is especially relevant given the ongoing interest and opacity surrounding the principal auditor's use of affiliated and non-affiliated firms to perform significant audit procedures.¹³ We agree with Acting Chairman Goelzer that these requirements should "make audit committee oversight more effective by arming the committee with up-front information regarding the auditor's view of the risks and how they will be addressed."¹⁴

Third, we strongly support the Proposal's additions to the existing communication requirements relating to accounting policies, practices, and estimates.¹⁵ In particular, we support the new requirements that auditor communications to the audit committee include a discussion of:

- "[S]ignificant accounting matters on which the auditor has consulted outside the engagement team."
- "[A]ny significant changes to assumptions or processes made by management to the critical accounting estimates in the year under audit, a description of the reasons for the changes, the effects on the financial statements, and the information that supports or challenges such changes."
- "When critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and how various selections within the range would affect the company's financial statements."¹⁶

We agree with Acting Chairman Goelzer that these "topics are particularly relevant in light of the additional attention that the economic crisis has brought to management's judgments and estimates"¹⁷ We also agree with PCAOB Board Member Steven B. Harris that the knowledge gained from communications focusing on the critical financial reporting decisions made by management are "vital for an audit committee to effectively oversee the financial reporting and auditing process."¹⁸

¹¹ Proposal, *supra*, at 8-9.

¹² *Id.* at 9.

¹³ See, e.g., PCAOB, Issuer Audit Clients of Non-U.S. Registered Firms in Jurisdictions Where the PCAOB is Denied Access to Conduct Inspections 1 (May 19, 2010), <http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx> (Noting that audit firms that have never been subject to a PCAOB inspection are performing significant audit work that is "relied upon by the issuer's principal auditor, in the U.S., or elsewhere").

¹⁴ Daniel L. Goelzer, at 1.

¹⁵ Proposal, *supra*, at 10-13.

¹⁶ *Id.* at 11-12.

¹⁷ Daniel L. Goelzer, at 1.

¹⁸ Steven B. Harris, Board Member, Statement on Proposed Auditing Standard Related to Communications with Audit Committees 2 (Mar. 29, 2010), http://pcaobus.org/News/Speech/Pages/03292010_HarrisStatement.aspx.

Finally, we note that our general support for the Proposal does not diminish our continued support for improvements to communications between outside auditors and *shareowners*. While the audit committee must actively communicate with auditors to fulfill their oversight responsibilities, investors also need better communications with the auditor to fulfill their ownership responsibilities—namely to make an informed vote in connection with the ratification of auditors that occurs annually at most public companies.¹⁹

Unfortunately, the primary means by which the auditor currently communicates with shareowners is through the auditor's report.²⁰ Many shareowners and other users of audited financial statements are dissatisfied with content of the auditor's report that, incredibly, has seen little change since the 1930's.²¹ We, therefore, encourage the PCAOB, consistent with the recommendations of the Department of the Treasury's Advisory Committee on the Auditing Profession,²² to aggressively pursue improvements to the auditor's standard reporting model as well as consider other potential changes that would enhance the communications between auditors and shareowners.

Thank you again for the opportunity to provide comments in response to the Proposal. If you have any questions regarding this letter, please feel free to contact me at (202) 261-7081 or jeff@cii.org.

Sincerely,



Jeff Mahoney
General Counsel

¹⁹ See, e.g., Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report VIII: 20 (Oct. 6, 2008), <http://www.ustreas.gov/offices/domestic-finance/acap/> (Although not statutorily required, the majority of public companies in the United States—nearly 95% of S&P 500 and 70%-80% of smaller companies—put auditor ratification to an annual shareholder vote"); Cf. Council of Institutional Investors, **§ 2.12f Shareowner Votes on the Board's Choice of Outside Auditor** (Providing that audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor).

²⁰ Department of the Treasury, at VII:13.

²¹ *Id.* at VII: 13; 16; see also CFA Institute, Independent Auditor's Report Survey Results 3 (Mar. 2010), http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf (Finding that "94 percent of respondents would like to see additional information in the auditor's report").

²² Department of the Treasury, at VII:13 ("**Recommendation 5: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model**").