



National Association of State Boards of Accountancy

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◆ 150 Fourth Avenue, North ◆ Suite 700 ◆ Nashville, TN 37219-2417 ◆ Tel 615.880-4201 ◆ Fax 615.880.4291 ◆ [www.nasba.org](http://www.nasba.org) ◆

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

[Via e-mail to comments@pcaobus.org](mailto:comments@pcaobus.org)

Re: “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,” PCAOB Rulemaking Docket No. 34.

Dear Members of the Public Company Accounting Oversight Board:

We appreciate the opportunity to provide comments on “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” (the Proposal) issued by the Public Company Accounting Oversight Board (PCAOB or the Board). The National Association of State Boards of Accountancy’s (NASBA) mission is to enhance the effectiveness of the licensing authorities for public accounting firms and certified public accountants in the United States and its territories. Our comments on the Proposal are made in consideration of our ability as state regulators to adjudicate based on the proposed standards. In furtherance of that objective, we offer the following recommendations.

We support the Board’s efforts to modify the auditor’s report so that it is more useful to investors. The more information of value auditors are able to provide to the users of audited financial statements, the greater the value and relevance auditors can provide to the capital markets.

Specifically, we are supportive of the following changes to the auditor’s report:

1. Providing clarity regarding the responsibilities for other information included within the 10-K.

2. Including a statement that the auditor is required to be independent under the applicable rules and regulations.
3. Additional standardized language regarding the auditor's responsibilities with respect to the detection of error or fraud and performing procedures to assess the risks of material misstatement.
4. Making it clear that the audit includes the notes to the financial statements.

### **Critical Audit Matters**

#### **General Support**

With respect to the disclosure of Critical Audit Matters (CAMs), we support the underlying principle of providing meaningful and useful information to investors and other financial statement users. Certain disclosures, however, will potentially be at odds with the historical reporting model, which has management being responsible for the company's financial statements and disclosures and the auditor attesting to that information.

In responding to the Board's request for comments on the proposal, we also offer the following overall observations:

1. We have been following the International Auditing and Assurance Standards Board's (IAASB) proposal and applaud the Board's efforts in working with the IAASB on this proposal as it is important they be aligned.
2. With such significant changes being proposed, an important fiduciary duty exists to ensure that any changes adopted narrow the expectation gap between the understandings/perceptions by users regarding the audit and the reality of what an audit, which provides reasonable assurance, can achieve.
3. Changes that are market driven add value for users of financial statements, but they should be made with appropriate consideration of costs and benefits.
4. As the State Boards will be adjudicating based upon the PCAOB's rules, we would like to avoid requirements that would result in challenging implementation issues. Consequently, we ask the Board to give added consideration to including:
  - a. Unique disclosures over time becoming boilerplate and, as a result, whether the Board's objectives of providing useful information to investors will be achieved.

b. The questioning of what is considered to be a CAM through the PCAOB inspection process and whether restatements of auditors' reports may be required as a result. We note that a failure to report a CAM does not mean that the financial statements were not fairly presented in accordance with generally accepted accounting principles, or that the audit procedures applied to determine whether or not the financial statements were determined in accordance with such principles were not in accordance with generally accepted auditing standards issued by the PCAOB.

We have concerns that the proposed requirements may result in matters being reported by the auditor that are not required to be reported by management which could lead to investor confusion.

We also have concerns that:

- Trying to describe the procedures related to CAMs in an extensive way that is understandable to readers will be challenging and may not add value.
- The sample reporting examples in Appendix 5 of the Proposal do not illustrate the reporting requirements as stated in the proposed standard (e.g., discussion of audit procedures, use of specialists, national consultation, etc.).

As state laws reference or adopt these requirements, we see potential practical implementation challenges, including:

- Suppose the auditor encounters a potentially illegal act. Arguably, this could meet the definition of a CAM; however, including discussion regarding an illegal act in the auditor's report may not be either sufficient or appropriate.
- The same matter may be considered a CAM in one year, but not another. Consequently, comparative disclosures may become very complicated.
- Continued use of emphasis of matter (EOM) paragraphs: As proposed, it is unclear how an overlap between CAM and EOM paragraphs would be addressed.

Based on the above, we offer the following suggestions:

1. Provide greater clarity regarding what should be considered a CAM.
  - a. Narrow the starting population of potential CAMs to only those matters discussed with the Audit Committee - under AS 16 and other applicable PCAOB standards (the proposed IAASB standard has a similar requirement to this).

- b. Provide additional guidance, beyond that included in paragraphs 9 and 10 of the proposed auditor reporting standard, that provides further clarity on how the auditor should filter potential CAMs to those that are ultimately reported in the auditor's report.
  - c. Recommend that the extent of communications with the audit committee about a potential CAM be an additional filter to apply in the final determination of what the CAMs are.
  - d. Limit CAMs to those matters already disclosed in the financial statements.
2. Provide greater clarity regarding the communication of CAMs in the auditor's report and guidance if the communication of CAMs should include a discussion of audit procedures performed. If it is the Board's intent for the auditor to include a discussion of procedures, suggest that an explicit statement be added to the auditor's report that states the CAM disclosure is not the totality of all procedures performed on a CAM and/or additional guidance for the procedures the auditor should include.
  3. Provide additional guidance for the documentation requirements with respect to matters ultimately concluded not to be CAMs.
  4. Include a statement in the standard that, in a situation where there is overlap between a CAM and an EOM, they should be integrated so as to avoid duplication/repetitiveness in the auditor's report.
  5. Include the concept that each year the auditor takes a fresh look at CAMs and does not maintain a "rolling inventory" of CAMs.

#### **Matters Not Required to be Disclosed in the Financials but by Definition are CAM**

The Proposal uses an example of a loss contingency that was a complex matter but which management and the auditor concluded did not have to be disclosed in the financial statements. The Proposal says that the matter should be disclosed in the audit report as CAM. If GAAP does not require disclosure of a matter, regardless of the complexity of the matter, from a regulatory standpoint, we question the appropriateness of the audit report requirement as CAM. In addition, such disclosure in the audit report would likely confuse readers because there would be no explanation of the matter in the financial statements.

#### **References to Relevant Financial Statement Accounts and Disclosures**

The Proposal requires the auditor to: "Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable." The norm for references to

financial statements in the auditor's report today is for the auditor to refer to a footnote disclosure in the financial statements, not financial statement accounts, as the footnote disclosures will typically reference to the amounts in the financial statement accounts. We suggest that references in the auditor's report to CAM be limited to reference to disclosures.

### **Conformity with International Standards**

The IAASB's recently issued an exposure draft, "Reporting on Audited Financial Statements Proposed New and Revised International Standards on Auditing (ISAs)" that uses the term "Key Audit Matters" in the same manner that the PCAOB uses the term "Critical Audit Matters." We suggest that the PCAOB, the IAASB and the Auditing Standards Board use similar terminology, definitions and requirements wherever possible.

### **Communication of CAM in Writing by the Auditor to the Audit Committee**

Under present standards, when an auditor communicates with the audit committee, the communication does not have to be in writing. The auditor only has to document the information that was communicated orally. The Board has recently issued an auditing standard that enhances communication of auditors with audit committees. We believe that the Board should revisit the issue of permitting only oral communication and require in the instance of CAM that, because of its significance, CAM be communicated in writing.

### **Other Information**

The Proposal updates the current PCAOB auditing standard for "Other Information" and adds a section in the auditor's report that addresses the auditor's responsibility for evaluating "Other Information." We support the addition of this section to the auditor's report.

The proposed new paragraph says that the auditor has evaluated whether the "Other Information" included in the annual report filed with the SEC contains a material inconsistency with the financial statements in the annual report, a material misstatement of fact, or both.

The proposed auditor's report does not include a definition of "Other Information." We suggest that the commonly understood Auditing Standards Board's definition of what constitutes "Other Information" (AU-C 720) be retained. Consider limiting auditor involvement to Management's Discussion and Analysis, including Critical Accounting policies.

We are suggesting this change, as there are several practical challenges with the proposed audit procedures, including:

1. The auditor does not have a basis or the knowledge to evaluate all qualitative statements in the 10-K. Examples include backlog, executive compensation, marketplace position, etc.
2. It is unclear what will be expected in terms of documenting the procedures with respect to other information.
3. The standard does not address the documentation aspect: How does an auditor document that he/she “read and evaluated”?
4. It is unclear if the auditor is obligated to aggregate immaterial inconsistencies with the financial statements or immaterial misstatements of fact and evaluate them on a collective basis.

### **Retention of Pass/Fail Model**

We agree that the Pass/Fail Model should be retained. As noted earlier with such significant changes being proposed, an important fiduciary duty exists to ensure that any changes adopted narrow the expectation gap between the understandings/perceptions by users regarding the audit and the reality of what an audit, which provides reasonable assurance, can achieve.

### **Auditor Independence**

We support the proposed addition of a paragraph addressing auditor independence. Stating in the auditor’s report that the auditor is independent in accordance with federal laws and regulations and the rules of the Securities and Exchange Commission and the PCAOB will help financial statement users understand that the auditor must comply with these laws, regulations and rules, and not rules issued by other organizations.

### **Tenure of Service**

#### **Proposed Sentence Regarding Tenure of Service**

The Proposal includes a sentence addressing tenure of service at the end the proposed new paragraph in the auditor’s report addressing auditor independence. The sentence is: “We or our predecessor firms have served as the Company’s auditor consecutively since [year].”

The Proposal also cites a rule adopted by the UK Financial Reporting Council that requires UK companies to provide information on the length of auditor tenure in a separate section of their annual report and not in the auditor’s report.

**Proposed Placement of Tenure of Service Sentence**

We believe that the placement of the proposed sentence on auditor tenure as the last sentence in the paragraph on auditor independence clearly creates a link between auditor independence and tenure of service.

Yet, as the Proposal states, the PCAOB has not reached a conclusion regarding the relationship between audit quality and auditor tenure, and the PCAOB's inspection process has not been designed to determine such relationship.

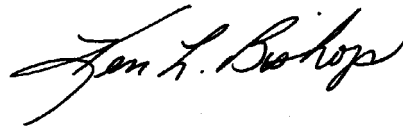
Please consider the potential negative implication of the placement of the sentence on tenure in the last sentence in the auditor independence paragraph. We suggest that the sentence on tenure of service be placed in a paragraph immediately above the auditor's signature.

We appreciate the opportunity to respond to the Proposal referenced above.

Sincerely,



Carlos E Johnson, CPA  
NASBA Chair



Ken L. Bishop  
NASBA President and CEO