



August 15, 2016

Ms. Phoebe W. Brown  
Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, DC 20006-2803

Re: Proposed Auditing Standard on the Auditor's Report on an Audit of Financial Statements  
When the Auditor Expresses an Unqualified Opinion; Docket Matter No. 34

Dear Ms. Brown:

The Independent Directors Council and the Investment Company Institute<sup>1</sup> appreciate the opportunity to comment on the Public Company Accounting Oversight Board's proposed changes to the auditor's reporting model.<sup>2</sup> The Proposed Auditor Reporting Standard would make several changes to the auditor's report intended to make it more informative to investors. In particular the Proposal would, among other things: require communication of critical audit matters (CAMs), which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit; require disclosure of auditor tenure in the auditor's report; and clarify the auditor's existing responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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<sup>1</sup> The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of \$17.9 trillion and serve more than 90 million U.S. shareholders. IDC serves the U.S.-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

<sup>2</sup> See The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, PCAOB Release No. 2016-003 (May 11, 2016) (Release). The Release includes a proposed audit standard, which we refer to as the "Proposed Auditor Reporting Standard" or the "Proposal" and proposes certain changes to other audit standards.

The Proposal is a reproposal of a 2013 proposal on which we commented.<sup>3</sup> We are pleased to see that the Board has made several changes to the 2013 proposal relating to audits of investment company financial statements that address comments raised by us and others. Specifically, the Proposed Auditor Reporting Standard indicates that communication of CAMs is not required for audits of investment companies registered under the Investment Company Act of 1940 (Investment Company Act). The Proposal would also specify how auditor tenure should be measured in the context of a group of investment companies.

We strongly support the Board's decision to exclude audits of registered investment companies from CAM reporting. We believe there would be little, if any, benefit of CAM reporting to fund shareholders in light of the purpose and structure of funds, and disclosures that they currently provide in their prospectus and shareholder report. We are concerned, however, that the disclosure of auditor tenure in the auditor's report may imply a relationship between auditor tenure and audit quality and recommend that tenure instead be disclosed in PCAOB Form AP. We elaborate on these and other comments below.

### *CAM Reporting*

Investment companies are designed to provide investors with access to a professionally managed portfolio of investment securities. Funds can invest in a variety of stocks, bonds, and other securities, providing investors with pro-rata ownership of a diversified portfolio with a modest initial investment. The Investment Company Act includes specific requirements intended to reduce investors' risks in areas such as portfolio diversification, liquidity, leverage, and custody of securities. Funds provide extensive disclosure to investors that describes their investment objectives and policies, risks, fees, expenses, and performance. Unlike operating companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. Any material changes must be approved in advance by a vote of fund shareholders. Because of the purpose and structure of investment companies, we believe that CAM disclosure would provide little if any benefit to fund investors and would have the potential to become repetitive, making it uninformative.

For investment companies, the audit matters most likely to be deemed critical under the Proposal would involve the auditing of security values. Generally accepted accounting principles currently require extensive disclosure regarding valuation of investments, with particular emphasis on securities for which observable prices are not available (*i.e.*, Level 2 and Level 3 securities).<sup>4</sup> The SEC's

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<sup>3</sup> See Letter from Amy B.R. Lancellotta, IDC Managing Director, and Gregory M. Smith, ICI Senior Director, to Phoebe W. Brown, PCAOB Secretary, dated December 11, 2013.

<sup>4</sup> See FASB ASC 820-10-50.

investment company registration forms require disclosure of the fund's valuation policies, including the use of "fair value pricing" and the effects of fair value pricing.<sup>5</sup> Because of these disclosure requirements, we believe investors are well informed about the extent of the fund's investments in securities that present difficult or subjective fair value measurements. We believe that requiring the auditor to describe the difficulty associated with auditing these fair value measurements would not add meaningfully to the mix of information already provided to investors. Indeed, CAM disclosure indicating that certain securities trade less frequently and were valued through reference to unobservable inputs would be repetitive of information already provided by management.

Funds in an investment company complex that have the same fiscal year end often issue a combined shareholder report that covers several different funds. In these instances the auditor typically issues one auditor report that covers all of the funds included in the shareholder report. If the Board were to require investment company auditor reports to include CAMs, we believe it may be confusing to shareholders if an auditor report covering multiple funds included CAMs for some, but not all of the funds covered by the auditor report. Alternatively, if auditors were to prepare separate auditor reports for each fund in the shareholder report, then the shareholder report would include multiple auditor reports, likely increasing the fund's costs to print and mail the shareholder report. Such costs would be borne by the fund and its shareholders.

For the reasons described above, we support the Board's decision to exclude auditor reports for investment companies registered under the Investment Company Act from CAM reporting.

#### *Auditor Tenure*

We are concerned that disclosure of auditor tenure in the auditor's report may cause investors to infer a relationship between auditor tenure and audit quality. As the Release recognizes, academic research on the relationship between tenure and audit quality has varied conclusions.<sup>6</sup> Some research indicates that engagements with short-term tenure are relatively riskier or that quality improves when auditors have time to gain expertise in the company under audit and in the related industry. Other research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality. The Board's 2013 proposal on the auditor's reporting model indicates that the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure.<sup>7</sup>

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<sup>5</sup> See e.g., Item 11 and Item 23 of SEC Form N-1A.

<sup>6</sup> See Release at 91.

<sup>7</sup> See PCAOB Release No. 2013-005 (August 13, 2013) at page A5-16.

In order to reduce the likelihood of any inappropriate conclusions being drawn from the relationship between auditor tenure and audit quality, we recommend that auditor tenure be disclosed in recently adopted PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*. Form AP, when implemented, will provide investors with the name of the engagement partner for each audit in a single searchable database. We believe disclosure in Form AP will provide investors with easy access to tenure information while reducing the likelihood of inappropriate conclusions being drawn from the relationship between auditor tenure and audit quality.

#### *Tenure Measurement for Investment Companies*

The Proposal specifies that for an investment company that is part of a group of investment companies, the auditor's tenure would be measured from the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. "Group of investment companies" for this purpose means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services, consistent with Section 12(d)(1)(G)(ii) of the Investment Company Act. This term would exclude other entities in the investment company complex, such as the investment adviser, any private funds, or entities that provide services to investment companies.

We support the Proposal's methodology for measuring tenure. The proposed methodology is appropriate given that all of the funds within a complex are on the same accounting system and are subject to the same system of internal control over financial reporting. Furthermore, many fund complexes have one board of directors that oversees all the funds in the complex and it is the board's responsibility, by statute, to select a fund's auditor.<sup>8</sup>

#### *Explanatory Language Regarding Audits of Internal Control Over Financial Reporting*

Unlike many operating companies, investment companies registered under the Investment Company Act are not required to engage an auditor to perform an audit of their internal control over financial reporting (ICFR).<sup>9</sup> Under current audit standards, auditors may, at their discretion, include a statement in the auditor's report indicating that they were not engaged to perform an audit of ICFR. For example, an investment company auditor's report may state:

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<sup>8</sup> See Section 32 of the Investment Company Act.

<sup>9</sup> See Section 405 of the Sarbanes-Oxley Act of 2002. Investment companies are, however, required to file with the SEC an auditor's report on the fund's internal control based on the results of procedures performed in obtaining an understanding of internal control over financial reporting and assessing control risk in connection with the audit of the fund's financial statements. This report must describe any material weaknesses identified. See Item 77B of SEC Form N-SAR.

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The Fund is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the fund's internal control over financial reporting. Accordingly, we express no such opinion.

The Release requests comment on whether auditor's reports for investment companies should be required to include an explanatory statement indicating that the auditor was not engaged to perform an audit of ICFR. We observe that certain audit firms routinely include such a statement in their auditor's reports for investment companies and that others do not. In order to better inform investors that rely on auditor's reports, and to increase consistency in auditor's reports, we recommend that the Board require an explanatory statement.

*Auditor's Responsibility to Obtain Reasonable Assurance*

The Proposed Auditor Reporting Standard would revise the auditor's report to better recognize the auditor's responsibility, under existing audit standards, to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud. Specifically, the phrase "whether due to error or fraud" would be added to the report when describing the auditor's responsibility to obtain reasonable assurance that the financial statements are free of material misstatement. The Board has proposed this change to clarify the auditor's role in detecting fraud, as the current report makes no explicit reference to fraud. We believe the proposed disclosure better informs investors of the auditor's responsibility and we support adding it to the auditor's report.

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If you have any question on our comments please contact Amy Lancellotta at (202) 326-5824 or [amy@ici.org](mailto:amy@ici.org), or Gregory Smith at (202) 326-5851 or [smith@ici.org](mailto:smith@ici.org).



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