



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

OFFICE OF THE  
INVESTOR ADVOCATE

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**Submitted Electronically**

Phoebe W. Brown  
Office of the Secretary  
PCAOB  
1666 K Street, NW  
Washington, DC 20006-2803

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

Dear Madam Secretary:

The Office of the Investor Advocate<sup>1</sup> at the U.S. Securities and Exchange Commission (“Commission” or “SEC”) monitors developments in accounting and auditing, and we strive to ensure that the interests of investors are appropriately considered as rules are modified. We appreciate this opportunity to provide comments in regard to the repropoed standard, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.<sup>2</sup>

In summary, we support PCAOB’s repropoed standard, which we believe advances the Board’s statutory mandate to “protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.”<sup>3</sup> In particular, we strongly support the repropoed requirement for the audit report to include communication of critical audit matters (“CAMs”) arising from the audit that required especially challenging, subjective, or complex auditor judgment, and of how the auditor responded to those matters. We also support the proposed additional improvements to the Auditor’s Report, including a requirement for a statement regarding the auditor’s tenure, and measures to improve the form of the auditor’s report. We believe these improvements will enhance the usability of audit reports for investors and other users.

**Why Critical Audit Matters (CAMs) Are Needed**

Investors and others have often argued that the current reporting model should be expanded to provide information specific to the audit of the company’s financial statements. One investor organization has

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<sup>1</sup> This letter expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for this letter and all analyses, findings, and conclusions contained herein.

<sup>2</sup> PCAOB Rulemaking Docket Matter No. 034, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, (May 11, 2016), <https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf> (hereinafter “Reproposal Release”).

<sup>3</sup> Section 101(a) of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”).

described the standard reporting model as “bare-bones” and “seriously outdated.”<sup>4</sup> We agree, and we believe that the inclusion of critical audit matters (CAMs) in auditor reports will improve their communication value and make them more usable for investors.

Calls to enhance the auditor’s report are not new. In 2008, the U.S. Department of the Treasury Advisory Committee on the Auditing Profession (“ACAP”) recommended 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.<sup>5</sup> ACAP noted that greater complexity in financial reporting, including the increasing complexity of global business operations and growing use of judgments and estimates, supported improvements to the auditor’s report. Moreover, as far back as 1978, the Commission on Auditors’ Responsibilities (Cohen Commission) made an observation that still rings true today:

For the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor’s standard report compresses that considerable expenditure of skilled effort into a relatively few words and paragraphs.<sup>6</sup>

The current pass-fail model has persisted for more than 70 years. The longevity of the standard reporting model, which arguably reflects the merits of the pass-fail model, nonetheless stands in contrast to the changes that have coursed through financial markets and financial reporting over the past decade and that continue to do so. These changes include the growing use of complex accounting estimates and fair value measurements, which we believe contributes to the information asymmetry between investors and management. Forthcoming fundamental accounting changes, including those involving the bedrock of revenue recognition, will make it even more imperative for investors to understand management’s judgment. The due deliberation in which the PCAOB has been engaged for more than five years clearly makes the case for the proposed improvements, in particular in the communication of critical audit matters.

In this still-evolving environment of financial complexity, the disclosure of CAMs holds the promise of contributing to investors’ understanding by communicating the most challenging, subjective, or complex auditor judgments on material issues that auditors face. We don’t expect CAMs, in themselves, to provide investors with all the information they need in the face of growing financial complexity. We do, however, believe that the communication of critical audit matters will add to the total mix of information, contributing to the ability of investors and others to analyze companies, form a multifaceted understanding of them, and make informed investment decisions.

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<sup>4</sup> CFA Institute, Comment Letter on PCAOB’s 2013 Proposal, (Dec. 30, 2013), [https://pcaobus.org/Rulemaking/Docket034/232b\\_CFA\\_Institute.pdf](https://pcaobus.org/Rulemaking/Docket034/232b_CFA_Institute.pdf).

<sup>5</sup> ACAP, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (Oct. 6, 2008), at VII:17.

<sup>6</sup> As quoted in ACAP, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (Oct. 6, 2008), at VII:15.

As the record assembled by the PCAOB makes clear, investors generally support the inclusion of CAMs to enhance auditor reports. The Reproposal Release (Part VI, Economic Considerations, in particular) lays out a compelling case as to why the proposed improvements will reduce informational asymmetries and add to the total mix of information available to investors.

Investors want to hear directly from the auditor. As the Reproposal Release observes, “Because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility.”<sup>7</sup> Surveys of professional investors also confirm “that additional information from the professional auditor in the [Standard Auditor Report] is of much higher interest and value to an investor in addition to hearing more from the audit committee.”<sup>8</sup> Certain academic research, as well as comment letters from knowledgeable investors, further reiterates this point.<sup>9</sup>

Investors can be expected to use CAMs in a wide variety of ways, reflecting the rich diversity of investors and their experience, resources, strategies and other attributes. Let me suggest three examples of how investors may use CAMs.

1. CAM disclosures can serve to focus users’ attention on key financial reporting issues and identify areas that deserve more attention. For example, an investor may find that a set of CAMs confirms his or her analysis of key audit issues, or, alternatively, may surprise the investor and point the way for further analysis. In this way, CAMs can boost the efficiency of investors and others in the consumption of financial information.
2. The disclosures can facilitate a more focused and richer dialogue between investors and the company. Even without providing original information about the company, the communication of CAMs can highlight areas that investor may wish to emphasize in their engagement with a company. If a critical audit matter is important enough to merit a conversation between the auditor and the audit committee, investors may determine that it could also merit discussion in their conversations with management.
3. The disclosures offer important information that investors can use in making proxy voting decisions, including ratification of auditors.

We also believe that CAMs may have a salutary effect on the behavior of auditors, company management, corporate boards and their audit committees. By heightening the focus on critical audit matters, the communication of CAMs may provide incentives for preparers, corporate managers and audit committees to provide better disclosures, adopt more widely accepted financial reporting approaches, and enhance audit quality. That’s a win-win for investors and companies alike – as well for our capital markets and economy at large. All will benefit if the communication of CAMs enhances the

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<sup>7</sup> Rulemaking Docket Matter No. 034, Proposed Auditing Standards on the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information and Related Amendments (“Docket 034”).

<sup>8</sup> CFA Institute, *supra* note 4 at 3.

<sup>9</sup> *See generally*, Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors’ Decision to Invest? 33 *Auditing: A Journal of Practice & Theory* 71, 71–93 (2014); Jack T. Ciesielski, Comment Letter on Reproposal Release (July 25, 2016), [https://pcaobus.org/Rulemaking/Docket034/8c\\_JTCiesielski.pdf](https://pcaobus.org/Rulemaking/Docket034/8c_JTCiesielski.pdf).

quality of audit information and thus ultimately helps to reduce the cost of capital and raise the efficiency of capital allocation.<sup>10</sup>

### **Disclosure of Auditor Tenure: A Question of Where, not Whether**

In addition to the disclosure of CAMS, we strongly support requirements for public disclosure of auditor tenure. There are some differences of opinion about who is best positioned to make the disclosure (the auditor, company management, or the board audit committee) and where that disclosure should be made (in the auditor's report, on Form AP, in the audit committee's report, in the company's proxy statement, or elsewhere). However, we believe these questions are secondary, and that the more important and more immediate concern is the need for the disclosure *somewhere* that is easily accessible. In the absence of such a requirement by the SEC, the PCAOB should move forward with its proposal to require disclosure of auditor tenure.

In its Concept Release on Possible Revisions to Audit Committee Disclosures, the SEC asks whether information on auditor tenure should be required in the audit committee report.<sup>11</sup> At least one institutional investor has favored disclosure in the proxy or elsewhere in a Form 10-K.<sup>12</sup> The CFA Institute, meanwhile, has expressed support for including the tenure information in the auditor's report in addition to EDGAR.<sup>13</sup>

Ultimately, we believe that the Commission should decide these questions. We hasten to add, however, that the worst outcome would be for *neither* the PCAOB or the Commission to adopt a disclosure requirement. Therefore, we recommend that the PCAOB take a two-pronged approach. First, the PCAOB should adopt a requirement for auditor tenure disclosure (either in the audit report or on Form AP). Second, we suggest that the PCAOB consider including a contingent sunset clause, such that the required disclosure in the audit report or on Form AP would expire if and when the Commission adopted a requirement for audit tenure disclosure in the audit committee report, proxy statement, or other document.

### **Enhancing Usability**

We commend the PCAOB for including several measures to enhance the usability of auditor reports. The repropoed standard would require the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The repropoed standard would also require titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report. These measures are relatively modest, but they would be a positive step for investors because they would enhance the clarity and comparability of disclosures.

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<sup>10</sup> Reproposal Release, *supra* note 2 at 76 ("Academic research has shown that increased quality of information could result in a reduction in the average cost of capital").

<sup>11</sup> See SEC, Possible Revisions to Audit Committee Disclosures, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015) ("SEC concept release").

<sup>12</sup> Blackrock Comment Letter on Reproposal Release, (Oct. 30, 2013)

[https://pcaobus.org/Rulemaking/Docket034/008b\\_Blackrock.pdf](https://pcaobus.org/Rulemaking/Docket034/008b_Blackrock.pdf).

<sup>13</sup> CFA Institute, *supra* note 4 at 8.

## **Materiality Component**

In response to earlier criticisms, the Board narrowed the scope of the CAMs disclosure in several ways, including adding a materiality component to the definition of critical audit matter.<sup>14</sup> Some investors have argued that the PCAOB pulled back too far in its adjustments. For example, the Council of Institutional Investors (“CII”) argued in its comment letter that the modified definition “is too narrow and unnecessarily excludes relevant information from investors.”<sup>15</sup> Another investor, in urging the Board to eliminate the materiality requirement for CAMs, argues: “Many cases of material accounting problems or fraud started as ‘immaterial’ to the financial statement and built over time....It is a serious deficiency in the proposal if investors would only hear about critical audit matters after suffering large losses which is the current disclosure paradigm.”<sup>16</sup>

These thoughtful investor criticisms of the Reproposal merit serious consideration. Despite this shortcoming, however, the reproposed standard represents a major improvement to the auditor model, and I encourage you to move forward swiftly to adopt these important reforms. And, if a materiality standard is ultimately adopted, the PCAOB should carefully monitor the implementation of the new standard to ensure that it does not create a significant disclosure gap.

## **Audits of Emerging Growth Companies (EGCs)**

As the Reproposal makes clear, the question of whether to apply critical audit matter requirements to the audits of EGCs is necessarily two-pronged. First, this is a policy question, which the PCAOB should judge on the merits of the issue. Second, the SEC will need to make a legal determination on whether such a requirement with respect to the audits of EGCs would accord with certain provisions of the Jumpstart Our Business Startups (“JOBS”) Act.<sup>17</sup>

From a policy perspective, we strongly believe that the proposed PCAOB standard should apply critical audit matter requirements to the audits of EGCs. The Reproposal Release itself makes a compelling argument:

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<sup>14</sup> Reproposal Release, *supra* note 2 at 3 (“The reproposal narrows the requirements in several ways: by limiting the source of potential critical audit matters to matters communicated or required to be communicated to the audit committee; adding a materiality component to the definition of critical audit matter; narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment; and revising the related documentation requirement”).

<sup>15</sup> Council of Institutional Investors, Comment letter on Reproposal Release (July 27, 2016), [https://pcaobus.org/Rulemaking/Docket034/010c\\_CII.pdf](https://pcaobus.org/Rulemaking/Docket034/010c_CII.pdf).

<sup>16</sup> Elizabeth F. Mooney and Dane Mott, The Capital Group Companies, Inc., Comment Letter on Reproposal Release (June 24, 2016). [https://pcaobus.org/Rulemaking/Docket034/03c\\_Capital.pdf](https://pcaobus.org/Rulemaking/Docket034/03c_Capital.pdf).

<sup>17</sup> Reproposal Release, *supra* note 2 at 108 (As explained in the Release, Section 104 of the JOBS Act provides that “[a]ny rules of the Board requiring . . . a supplement to the auditor’s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company. Section 104 further provides that any other rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC “determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.”)

A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.<sup>18</sup>

This heightened asymmetry of information makes us wary of the various regulatory attempts to further reduce information by waiving disclosure requirements for small or emerging companies in the name of “scaling.” Specifically with respect to CAMs, we believe that application of the communication requirements would result in even greater benefits for EGC investors than for investors in the broader population of operating companies. Moreover, these benefits would likely accrue not only to investors, but also to EGCs themselves. Both the companies and investors will benefit from such benefits as increased analyst coverage, higher trading volume, and lower cost of capital for EGCs.<sup>19</sup>

We recommend that the PCAOB adopt the proposed standard, and thereby advance the legal question to the SEC, which would then determine whether a CAMs requirement could be applied to audits of EGCs without running afoul of provisions in the JOBS Act. Moreover, to prepare for any outcome of that determination, we recommend that the PCAOB adopt language encouraging auditors, on a voluntary basis, to include CAM communications in the audit reports on EGCs.

### **Adopt and Monitor**

We strongly support final adoption of the Reproposal standards, which will represent a major change for the auditor reporting model and hold the promise of important benefits for investors and capital markets. Given the scope of the changes to the auditor’s reporting model, it will be especially important for the Board – along with the Commission, investors, analysts, preparers, company management and boards, and others – to monitor the implementation of the new rule. We offer three examples of the areas in which the proposed standard, once adopted, should be monitored.

First, some investors and other commenters have expressed concerns lest the new requirements merely result in a checklist approach and boilerplate, standardized language. Such an outcome would make it difficult for investors and other users to distinguish the critical audit matters involving one company from another’s. The reproposed standard attempts to address this risk by clarifying that the auditor is required to describe only the principal considerations that led the auditor to determine critical audit matters, and by emphasizing that the communication should be tailored to the audit to reflect the specific circumstances of the matter.<sup>20</sup> However, the new standard, if adopted, should be monitored to make

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<sup>18</sup> Reproposal Release, *supra* note 2 at 108.

<sup>19</sup> Reproposal Release, *supra* note 2 at 73-74 (As the Release notes, one study found a significant increase in trading volume particularly for companies about which there is less information available to investors as measured by lower analyst coverage).

<sup>20</sup> Reproposal Release, *supra* note 2 at 31 (“In response to comments, the reproposed standard clarifies that the auditor is required to describe only the principal considerations that led the auditor to determine that the matter is a critical audit matter.

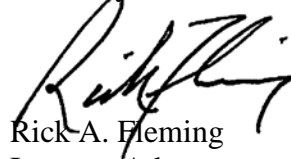
sure that the communication of CAMs does not devolve into mere boilerplate language, but instead provides the auditor's unique perspective on critical accounting matters.

Second, monitoring should assess the impact on investor understanding of the auditor's responsibilities and the audit report. Some have expressed concerns that investors and other users might mistakenly perceive an expanded auditor's report as providing a qualified or piecemeal opinion. The repropose standard specifically addresses these concerns by proscribing certain language in the auditor's report,<sup>21</sup> but its effectiveness should be evaluated over time. The standard, if adopted and implemented, should be monitored to confirm that the expanded audit report does not cause investor confusion but, on the contrary, enhances their understanding of critical audit matters and the financial statements of issuers.

Third, and more broadly, the PCAOB and others should continue to monitor how investors actually use the audit report and other financial information. As noted above, finance and financial reporting continues to grow in complexity. At the same time, technological advances in the delivery of financial information have facilitated the use of data aggregation and data analytics by investors and other users of financial information. We should monitor how investors use financial reporting and how their usage may evolve in the face of technological change.

Thank you, again, for the opportunity to submit our comments regarding this important matter. Should you have any questions, please do not hesitate to contact me or Stephen Deane, who handles audit and accounting matters on my staff, at (202) 551-3302.

Sincerely,



Rick A. Fleming  
Investor Advocate

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The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication would be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter").

<sup>21</sup> Reproposal Release, *supra* note 2 at A1-9 ("Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate").