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Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, D.C. 20006-2803

**Re: Request for Public Comment: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 34**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA).

The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board (PCAOB or the Board) on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ commends the PCAOB and its staff on the unprecedented outreach to investors, issuers, audit committee members, the auditing profession, and other stakeholders to inform the Concept Release and the thoughtful content put forward for public consideration. We are submitting for the Board's consideration our comments on the issues raised within the Concept Release which supplement the views expressed in our comment letter dated June 28, 2011 (Attachment A to this letter).

We have organized our observations into the following sections:

- I. Profession's Commitment to Responsible Change
- II. Holistic Approach Necessary for Responsible Change
- III. Value of Standardized Language
- IV. Reaffirmation of Suggested Approaches in the CAQ's June 28, 2011 Letter
  - a. Retention of the Pass/Fail Opinion
  - b. Addition of Clarifying Language to the Standard Auditor's Report
  - c. Supplemental Reporting in Addition to the Standard Auditor's Report
    - i) Separate Attestation Report on Critical Accounting Estimates in Management's Discussion & Analysis
    - ii) Use of Emphasis Paragraphs in the Standard Auditor's Report
- V. Views on Auditor's Discussion and Analysis (AD&A)
- VI. Other Considerations
- VII. Views on Auditor Assurance on Information Presented Outside the Financial Statements

## **I. Profession's Commitment to Responsible Change**

Recent views expressed by investors convey their desire for further information on a number of different financial reporting matters including, but not limited to, additional insight into accounting policies, particularly critical accounting estimates; more information about the independent audit; and information about the activities of public company audit committees, including their discussions of critical matters with management and the external auditors. The CAQ undertook the efforts described below in response to these calls for change.

### ***CAQ Auditor's Reporting Model Working Group***

The profession recognizes that change is needed to improve the information communicated to investors and supports change that would enhance the information available to financial statement users and the value of the audit. Accordingly, the CAQ established an auditor's reporting model (ARM) working group in 2010, comprised of members of the auditing profession, to consider how to best serve investors given their evolving information needs. The ARM working group explored a variety of possible alternatives for communicating additional information about the audit, including changes to the auditor's report combined with expanded disclosures by management or the audit committee.

Members of this working group met with PCAOB staff on February 7, 2011, to discuss the possible alternatives developed. Subsequent to this meeting, the ARM working group continued its efforts to identify and evaluate potential changes to the auditor's reporting model. On June 28<sup>th</sup>, the CAQ submitted a comment letter to the PCAOB that addressed certain ideas raised in the Concept Release. The letter describes suggested approaches for potential revisions to the auditor's reporting model that are believed to be: (i) responsive to the information needs we have heard from investors, (ii) practically implementable in a relatively short time frame and (iii) consistent with the overarching principles developed and used by the ARM working group as a framework for its deliberations (see details below). These overarching principles were discussed with the PCAOB staff in February, reiterated in the CAQ's June 28<sup>th</sup> comment letter, and are a basis for our views in this letter.



## ***Overarching Principles***

In evaluating this topic, the ARM working group established the following overarching principles, with investors in mind, to guide the development of possible areas for further consideration related to revisions to the auditor's reporting model:

1. Auditors should not be an original source of disclosure about the entity; management's responsibility should be preserved in this regard. As explored further in this letter, a fundamental shift from the auditor attesting to information prepared by management to the auditor providing original information about the company could result in unintended consequences that are not in the best interest of investors.
2. Any changes to the auditor's reporting model need to enhance, or at least maintain, audit quality.
3. Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
4. Any changes to the auditor's reporting model should add value and not lead to investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and the independent auditors.
5. Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective; however it is important that auditor communications provide objective information about these matters.

## **II. Holistic Approach Necessary for Responsible Change**

As discussed above, the CAQ recognizes the fundamental role of the auditor in serving the needs of investors and is prepared to embrace responsible calls for change related to the auditor's reporting model. We also believe that a holistic approach where all stakeholders agree on a way forward will best serve investors, and is a requirement if such change is to be lasting and meaningful. Such an approach should examine the roles and responsibilities of all members of the financial reporting supply chain to identify opportunities where changes can be made to better meet the needs of investors. Possible areas for further consideration include whether disclosures could be expanded or improved by preparers, whether audit committees could provide further information about oversight activities, how auditors could improve the information provided to investors through changes to the reporting model, and whether more useful information would be provided to investors through enhanced compliance efforts and/or additional rulemaking on the part of regulators/standard setters.

Pursuant to this approach, the ARM working group evaluated how auditors could better serve the needs of investors. We set forth below a suggested approach for improvements to the auditor's reporting model that we believe can be implemented in the shorter-term and are responsive to the needs of investors as articulated at the March 2011 PCAOB Investor Advisory Group (IAG) meeting and the CAQ's role of the auditor (RoA) roundtable discussion series (see further information below).

Our suggested approach includes the addition of clarifying language to the current auditor's report and a separate examination report on management's Critical Accounting Estimates (CAE) disclosure in Management's Discussion and Analysis (MD&A) and/or an emphasis-of-matter (EOM) approach anchored to the most significant matters in the financial statements.

The CAQ also believes that the PCAOB should further consider whether investors could benefit from auditor involvement with other information provided by management (including earnings releases, non-GAAP information, etc.) given the value that investors place on such information in making investment decisions. To

this end, the CAQ has established a separate RoA working group to further evaluate what additional services auditors might provide beyond their current responsibilities to better meet the needs of investors. Through a series of discussion roundtables, the RoA working group sought feedback from investors, analysts, audit committee members, preparers, attorneys and academics regarding how the auditor's role could evolve. We have published a summary report<sup>1</sup> which highlights observations from the discussion series and includes areas for further consideration related to possible improvements to the corporate reporting framework and the role of the auditor. Certain observations derived from these roundtable discussions have contributed to the views set forth in this letter which we describe in further detail below. We would be pleased to discuss the observations made in this report with the Board at a future date.

### **III. Value of Standardized Language**

In the course of discussions around possible improvements to the auditor's report, some have questioned the role of standardized language, and in some cases disparaged it as "boilerplate." This term connotes a lack of substance and unfairly diminishes the importance of the work and the resulting opinions reached by public company auditors. In contrast, we believe there is significant value in using standardized language in the auditor's report. As the PCAOB acknowledges in the Concept Release and in its Standing Advisory Group (SAG) briefing paper on this topic for the April 2010 SAG meeting, standardized language was implemented to provide consistent, comparable, and easily recognizable audit reports.<sup>2</sup>

We observe that the sentence that begins "[i]n our opinion" in the current standard report is carefully considered and represents the conclusion, in many cases, of thousands of hours of audit work. As mandated by the Sarbanes-Oxley Act (SOX), that audit work is monitored and approved by audit committees. It represents a significant investment by public companies on behalf of their shareholders, not only in financial terms but also in terms of time spent by the audit committee, management, and employees of the company at all levels in order to meet the demands of the audit. The auditor's opinion represents a professional conclusion reached only after compliance with extensive PCAOB auditing standards--standards that would not be met if the audit were off-the-shelf or otherwise failed to be appropriately tailored to the specific facts and circumstances of the individual company being audited.

We note that standardized language plays an important role in other settings in the securities markets as well. Further to that point, we would highlight the "negative assurance" letters that lawyers provide their clients in connection with securities offerings and the standard certifications that chief executive and chief financial officers must provide with their companies' periodic U.S. Securities and Exchange Commission (SEC) reports.

1. Lawyers provide so-called "negative assurance" letters containing standardized language in connection with securities offerings. Preparation of these letters requires hundreds of hours of work by the attorney but the letter itself is short and conclusory. The letters do not express the lawyer's subjective views on the quality and specifics of the disclosure in the offering materials but rather provide a standardized statement that the lawyer has no reason to believe that the disclosure violates the anti-fraud provisions of the securities laws. These letters play an important role in the "due diligence" process contemplated for securities offerings by the Securities Act of 1933 and are valuable, not in spite of containing standardized language, but because of it.

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<sup>1</sup> The CAQ report "Observations on the Evolving Role of the Auditor – a Summary of Stakeholder Discussions" is incorporated into this comment letter by reference, and is available at [www.thecaq.org/publications/EvolvingRoleoftheAuditor.pdf](http://www.thecaq.org/publications/EvolvingRoleoftheAuditor.pdf)

<sup>2</sup> See SAG Briefing Paper, *ACAP Committee's Recommendation Relating to the Auditor's Reporting Model* (April 2010). Available at: [http://pcaobus.org/News/Events/Documents/04072010\\_SAGMeeting/Auditor%27s\\_Reporting\\_Model.pdf](http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Auditor%27s_Reporting_Model.pdf)

2. Section 302 of SOX requires that an issuer’s principal executive officer and principal financial officer provide an express certification in each annual and quarterly report filed with the SEC. These certifications assert that the signing officers have reviewed the report, that the report does not contain any material false statements or omissions, that the officers are responsible for the issuer’s internal controls and that the financial statements included in the report “fairly present in all material respects the financial condition and results of operation of the issuer.” The SEC, in adopting rules implementing Section 302, has prescribed the exact wording of the “302 certifications” and has made it clear that executives may not vary the wording. In fact, if a certification is modified, a revised “clean” certification will be required by the SEC reviewers. This standardization, however, does not make the certifications any less powerful or meaningful to investors.

We make these points to remind all stakeholders in the financial reporting process that there is a purpose for standardized language in audit reports – it was instituted to provide comparability and assurance to investors regarding the audit process and financial reporting, and it continues to have value today. While we are supportive of responsible changes to the auditor’s reporting model, we encourage the Board to consider the important benefits of standardized language as it develops any modifications to the auditor’s reporting model.

#### **IV. Reaffirmation of Suggested Approaches in the CAQ’s June 28, 2011 Letter**

##### ***a. Retention of the Pass/Fail Opinion***

The Concept Release questions whether the current pass/fail model for the auditor’s report (i.e. whether the financial statements are fairly presented in all material respects with the applicable accounting framework) should be retained. We support the retention of the pass/fail model, but also believe the Board should consider enhancements to the auditor’s reporting model as discussed further below. Participants at the CAQ’s RoA roundtable discussion series agreed that the audit is valuable and the current pass/fail model for the auditor’s report should be retained.

##### ***b. Addition of Clarifying Language to the Standard Auditor’s Report***

The Concept Release also asks whether potential enhancements to the auditor’s reporting model should include the addition of clarifying language to the standard auditor’s report. As noted in the CAQ’s June 28<sup>th</sup> comment letter, we believe the addition of such language would be beneficial in narrowing the expectation gap by enhancing the understanding of the auditor’s role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain. We believe the addition of clarifying language will promote consistency in practice across audit reports. The CAQ does not believe that the addition of the clarifying language noted below will result in an increase in either the scope of the audit or the auditor’s responsibilities but rather will promote a better understanding of the auditor’s role and responsibilities.

We agree that the addition of clarifying language related to the following concepts is appropriate as described in the Concept Release and our June 28<sup>th</sup> comment letter:

1. *Reasonable Assurance* - Identify what is meant by the term “reasonable assurance.”
2. *Auditor’s Responsibility for Fraud* - Highlight that the auditor is responsible for planning and performing the audit to obtain reasonable assurance that the financial statements, taken as a whole, are free of material misstatement, “whether due to error or fraud.”

3. *Auditor's Responsibility for Financial Statement Disclosures* - Explicitly identify that the footnotes are an integral part of the financial statements and are covered by the audit report.
4. *Management's Responsibility for the Preparation of the Financial Statements* - Provide an expanded discussion covering management's responsibilities for the financial statements and the Form 10-K.
5. *Auditor's Responsibility for Information Presented Outside the Financial Statements* - Describe the procedures performed by auditors on information outside of the financial statements, including MD&A.
6. *Auditor Independence* - Identify that the auditor is independent within the meaning of all relevant SEC and PCAOB standards.

Further, as noted in our June 28<sup>th</sup> comment letter, we believe the following additional language not identified in the Concept Release will also provide added clarification for investors and is appropriate for further PCAOB consideration.

7. *Material Misstatements & Assessment of Materiality* - Identify what is meant by the term "material misstatement" and discuss the approach used by auditors to assess "materiality."
8. *Audit Committee Responsibilities* - Provide an expanded discussion covering audit committee responsibilities.
9. *Addressing the Audit Report* - Address the audit report to the shareholders of the company in addition to the Board of Directors.
10. *Professional Judgment* - Highlight the necessity of using professional judgment in assessing audit risk, selecting audit procedures and considering the issuer's internal control over financial reporting when responding to such risks.
11. *Additional Information About Public Company Audits* - Include a reference and link to where more information about public company auditing can be found (for example, the CAQ's *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*<sup>3</sup>), similar to the approach utilized in the United Kingdom.
12. *Scope Limitations and Non-Compliance with U.S. Generally Accepted Accounting Principles (GAAP)* - Outline the auditor's responsibility in the event a conclusion is reached that the financial statements are not presented in accordance with GAAP or situations where the audit scope is limited.
13. *Firm Network Structure and Responsibilities* - Where applicable, describe the accounting firm network structure, the responsibility of the member firm signing the audit report, and the participation of other member firms in the audits.

**c. *Supplemental Reporting in Addition to the Standard Auditor's Report***

In addition to adding clarifying language to the standard auditor's report, the CAQ's June 28<sup>th</sup> comment letter provides examples of supplemental reporting that could be made by the auditor including a separate attestation report on CAE disclosure in MD&A and the use of EOM paragraphs within the standard auditor's report. The CAQ believes that these approaches are responsive to many of the information needs heard from investors and can be practically implemented in a relatively short timeframe. While we describe both approaches below, we appreciate that adopting both of these alternative enhancements may not be necessary. We believe that the attestation report on CAE disclosure in MD&A is the enhancement most likely to address

<sup>3</sup> See Center for Audit Quality's *In-Depth Guide to Public Company Auditing* (2011). Available at: [http://www.thecaq.org/publications/In-Depth\\_GuidetoPublicCompanyAuditing.pdf](http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf)

the needs of investors, but we recognize that each approach or a combination of the two also merits further consideration.

*i) Separate Attestation Report on Critical Accounting Estimates in MD&A*

The Concept Release questions whether there are other alternatives the Board should consider that are not contemplated in the Concept Release. The CAQ believes a new, separate attestation report on the examination of the issuer's CAE disclosure in its MD&A is an appropriate alternative for consideration, as illustrated in Example B in the CAQ's June 28<sup>th</sup> comment letter. This approach is similar to that suggested in the Concept Release with respect to providing assurance on a portion of MD&A. Benefits and considerations of this approach are discussed below.

***Benefits***

We believe auditor examination of management's CAE disclosure in the MD&A, communicated in a separate attestation report is responsive to the needs of investors and avoids many of the unintended consequences that we believe would result from the AD&A approach described in the Concept Release and discussed further below.

At the PCAOB's March 2011 IAG meeting, participants presented the results of an investor survey indicating a desire for further information including, among other things: the auditor's evaluation of significant estimates and judgments, the auditor's evaluation of accounting policies and practices, the disclosure of sensitivity analyses performed by the audit engagement team, and the disclosure of unusual transactions, restatements and other significant changes. Participants at the CAQ's RoA roundtable discussions also identified a number of disclosures that could first be improved by management and might be appropriate for further auditor association. The disclosures most commonly identified related to financial information contained in MD&A, including the company's critical judgments and accounting estimates. We believe much of the information sought by investors, including those areas noted in the IAG presentation, should be disclosed by management in the CAE section of MD&A in compliance with SEC Financial Reporting Codification Section 500 – *Information Outside of the Financial Statements*<sup>4</sup> (SEC Codification); however, we also believe that such disclosure could be improved through auditor association as we discuss further below.

According to the SEC Codification, “[w]hen preparing disclosure under the current requirements, companies should consider whether they have made 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.”

Any CAEs or assumptions meeting those criteria should be disclosed in a company's MD&A. The SEC Codification requires that CAE disclosures include “to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has 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. Since CAEs and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect.”

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<sup>4</sup>See SEC Financial Reporting Codification: 501.14. *Critical Accounting Estimates*

We believe that auditor attestation on CAE disclosure in MD&A will lead to an increased focus in this area by both management and the auditor and will result in more robust disclosure and improved information provided to investors. In addition, auditor attestation on the CAE disclosure will provide users of the financial statements with additional confidence in management's disclosures.

### ***Other Considerations***

Should the PCAOB determine that the attestation report on CAE disclosure in MD&A is a viable option, the SEC would need to further consider whether amendments to Regulation S-X are necessary to require this new attestation report. Likewise, SEC consideration of whether the consolidation of existing CAE guidance into Regulation S-K is necessary in order to encourage better management disclosure and assist the auditor's examination, including a clear identification of the CAE section in MD&A that would be covered by the examination report. While we appreciate that the adoption of this alternative includes incremental SEC actions, the CAQ believes this approach best addresses the evolving information needs of investors, while being more practicable and cost effective than auditor attestation on MD&A in its entirety.

#### ***ii) Use of Emphasis Paragraphs in the Standard Auditor's Report***

The Concept Release seeks comment on requiring the expanded use of emphasis paragraphs in all audit reports to highlight matters that are important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty, and to identify where those matters are disclosed in the financial statements.

As discussed in our June 28<sup>th</sup> comment letter, the CAQ believes the EOM approach is a viable method for highlighting such matters. In contrast to the Concept Release, however, the CAQ does not believe that emphasis paragraphs should include a reference to the audit procedures performed for the areas emphasized. The deliberations of the CAQ's ARM working group, which included challenging itself to develop examples of how such an approach would be implemented in practice, resulted in the determination that emphasis paragraphs should not describe audit procedures, since: (i) it may be difficult for users of the financial statements to understand these audit procedures without further context derived from dialogue with the auditor, (ii) succinct descriptions would not adequately describe significant and often complex audit procedures, and (iii) more thorough descriptions of audit processes could contribute to "disclosure overload" and detract from the purpose of providing useful information to investors.

We believe the emphasis paragraphs should be objective, fact-based discussions and should make specific reference to where such items appear in the financial statements. Example A in our June 28<sup>th</sup> comment letter illustrates how this approach might appear in practice. Below, we discuss further the importance of developing an appropriate auditor reporting framework for this approach.

### ***Benefits***

We believe an approach that requires emphasis paragraphs in audit reports as described above has several benefits. First, this approach responds to requests from investors at the PCAOB's March 2011 IAG meeting for the auditor to indicate in the audit report areas that are most significant in the financial statements and direct the user to where those matters appear in the financial statements and related disclosures. Similar requests were heard at the CAQ RoA discussion roundtables. Second, this method would retain the established role of the auditor attesting to information provided by management. Third, the reference within the auditor's report to management's financial statement disclosures could drive better disclosure practices, improving the quality of information provided to investors. Finally, this approach avoids many of the



unintended consequences that we believe would result from the AD&A approach described in the Concept Release and discussed further below.

### ***Importance of Auditor's Reporting Framework***

Subsequent to the issuance of our June 28<sup>th</sup> comment letter, the ARM working group has given further thought to a possible framework for an EOM approach and would be pleased to explore this subject further with the Board at a future date. The CAQ strongly believes that the most important element of a successful EOM approach is the development of an appropriate framework, with sufficient detail, to guide the auditor's determination of what matters should be emphasized in the auditor's report. We believe the most significant matters are those that, in the auditor's judgment, are viewed to be the most important to a reader's understanding of the financial statements. Such matters should not necessarily represent all matters that may be material to the financial statements, have been the subject of significant audit effort or have involved the use of judgment in determining the accounting conclusions.

Moreover, the most significant matters should relate to items appearing in the financial statements, and not to risks that may be inherent in the company's business model, industry, or the broader business environment (the disclosure of which are covered by other requirements in the federal securities laws). Specific facts and circumstances should dictate how many items the auditor determines require emphasis; however, the CAQ believes that an overly broad framework resulting in a large number of EOM paragraphs would minimize the overarching objective of emphasizing the most important matters.

For items that meet the criteria of the framework, we recommend that the auditor communicate the following:

- A brief, factual and objective description of the item, which should not include information that is not otherwise reflected in the company's financial statements and related disclosures; and
- The identification of where the item has been accounted for and disclosed in the financial statements.

The auditor's report should be revised to include language regarding the auditor's responsibility with regard to the items emphasized; at the same time, the language in the auditor's report addressing the financial statements taken as a whole should be retained (i.e., no separate form of opinion or conclusion should be provided for any specific item emphasized).

Lastly, during the PCAOB roundtable held on September 15, 2011, some participants seemed to view the EOM approach and the AD&A approach as interchangeable solutions. In our view, AD&A is not similar to and is, in fact, inferior to the EOM approach. As described in more detail below, AD&A runs contrary to each of the five overarching principles established by the ARM working group. An appropriately designed EOM approach, however, would retain management's role in providing original information about the company, focus auditor reporting on the objective rather the subjective, enhance audit quality, narrow the expectation gap, and enhance communication to investors.

### **V. Views on AD&A**

The Concept Release seeks views on the possibility of a supplemental narrative from the auditor via an AD&A as a way to "provide investors and other financial statement users with a view of the audit and financial statements through the auditor's eyes." The CAQ does not support the AD&A approach for the reasons outlined below. We believe the AD&A approach runs contrary to the overarching principles previously articulated, could result in significant unintended consequences that could be detrimental to audit quality, and differs from the views expressed by participants at the CAQ's recent RoA discussion series. We believe the unintended consequences associated with this approach outweigh any potential benefits of an

AD&A. Further, we believe our suggested approaches noted above (i.e., a separate auditor attestation report on management's CAE disclosure in MD&A and/or required EOM paragraphs in the auditor's report) are superior alternatives to an AD&A as they serve the information needs of investors and avoid the unintended consequences associated with AD&A.

### ***Consequences of Auditors Focusing on the Subjective Rather than Objective***

The AD&A approach would require auditors to communicate subjective rather than objective information. While financial reporting matters assessed by the auditor through the performance of the audit are often highly subjective, it is important that auditor communications provide objective information about these matters. We are concerned that such a shift in the nature of information communicated by auditors may result in several unintended consequences which may negatively impact investors. Our view is consistent with those of participants at the CAQ's RoA roundtable discussions who strongly resisted the notion of auditors providing their views regarding the quality of a company's accounting policies and practices through a mechanism such as an AD&A.

The contemplated AD&A approach would require the auditor to provide "perspectives" or "impressions" on matters related to the audit as well as on the company's financial statements, including management's judgments and estimates, accounting policies and practices, and difficult or contentious issues such as "close calls." The Concept Release acknowledges, that as intended, the AD&A could result in the auditor communicating some of the same information that the auditor communicates to the audit committee regarding these matters. The CAQ has significant concerns regarding any revisions to the auditor's reporting model that would require the auditor to issue a public general-use report communicating information similar to that provided to the audit committee. When such matters are communicated by the auditor to the audit committee, the audit committee has the benefit of further discussion with the auditor to explore complex matters at the appropriate level of detail. Additionally, the audit committee has the benefit of periodic communications with the auditor throughout the year as well as information derived through its oversight of the financial reporting process, which also provide further context. Since investors lack this context, the CAQ believes that an auditor's public communication to investors of such complex and subjective matters (e.g. through an AD&A) may not be constructive and could be misleading.

Additionally, we believe it would be very difficult for audit firms to provide consistency in reporting related to auditor's "perspectives" or "impressions" on management's reporting. Without consistency in what is communicated, the AD&A requirement would diminish the comparability between companies, including those in similar industries. One audit partner's subjective opinion regarding a "close call" or "preferable accounting treatment" may differ significantly from that of another, which could result in unintended consequences for an issuer in comparison to its peers.

Further, we believe that efforts to ensure AD&A consistency, which would likely include the need for consultations at a crucial time during audit conclusion, would most likely strain valuable audit firm quality control resources. Participants at the CAQ's RoA roundtable discussions and the PCAOB's September 15<sup>th</sup> roundtable expressed similar concerns regarding the ability of the auditor to prepare a tailored narrative and complete the necessary reviews within current SEC filing deadlines.

### ***Consequences of Auditors Communicating Original Information about the Company***

The AD&A approach would result in auditors communicating original information about the company, creating a fundamental shift from the auditor attesting to information provided by management to the auditor providing original information about the company. We believe this could result in several unintended

consequences including undermining the roles and responsibilities of the audit committee, management, and the auditor and a further widening of the expectation gap.

The CAQ believes that an AD&A requirement could undermine the established governance role of the audit committee. SOX strengthened the role of the audit committee by specifically vesting it with the authority and responsibility to oversee a company's auditor, including appointments, compensation, and resolution of disagreements between management and the auditor related to financial reporting. As a result, oversight of the financial reporting process and external audit on behalf of investors has improved through more frequent dialogue between the audit committee and auditor via periodic meetings, including executive sessions. Further, we also believe a requirement for auditors to discuss sensitive matters in AD&A, as contemplated in the Concept Release, could undermine the governance function of the audit committee by resulting in less robust discussions between the auditor, management and the audit committee for fear that such information would be communicated publicly in the AD&A. Any breakdown in this communication would negatively impact the effectiveness of the audit committee's oversight as well as audit quality, to the detriment of investors.

Additionally, we believe the responsibility of management for the preparation of the financial statements, including disclosures may also be undermined. Auditor communication of original information about the company, including information regarding management's judgments and estimates, accounting policies and practices and material matters, could create "dueling disclosures" between management and the auditor. If the potential for "dueling disclosure" compels management to change its disclosure in the financial statements to align with the auditor's communication in AD&A, this may effectively shift responsibility for the financial statement preparation from management to the auditor. It is unclear what impact this could have on overall management responsibilities as well as the quality of financial reporting. Additionally, it is unclear how this shift in roles could impact the independence of the auditor – who under current rules is prohibited from taking on any role that leads to acting or functioning as management. Audit committee members, preparers, and attorneys who participated in the CAQ's RoA roundtable discussions generally agreed.

Lastly, we believe that "dueling disclosures" could be subject to misinterpretation by investors in instances where there are differing views between management and the auditor. This concern was echoed by participants at the CAQ's RoA roundtable discussions who strongly believed that the auditor should not communicate original information about the company; rather, the auditor's established role of attesting to information provided by management should be retained. Further, there is also the risk that AD&A could contribute to the current state of "disclosure overload" as management and the auditor could often report identical or nearly identical information in separate communications. This is also consistent with what we heard from participants at our RoA discussion series.

### ***Auditor Independence***

The Concept Release contemplates an AD&A requirement for the auditor to discuss specific independence matters communicated to the audit committee under PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. We believe a public discussion regarding such matters in an AD&A is unnecessary due to the existing governance function of the audit committee to assess auditor independence on behalf of investors, the external monitoring of auditor independence (by the PCAOB, SEC, and the firm itself), and existing means by which the auditor can communicate independence to investors. Under current PCAOB standards, the auditor is required to be independent, and every auditor's report is required to be titled, "Report of Independent Registered Public Accounting Firm." The CAQ also supports adding clarifying language to the standard auditor's report explicitly stating that the auditor is independent, as discussed in Section IV.b. of this letter.



For the reasons outlined above, we do not support the AD&A approach but, as discussed elsewhere in this letter, we fully support other alternatives that we believe are superior to the AD&A approach and would meet the needs of investors without creating significant unintended consequences.

## **VI. Other Considerations**

We offer further views below regarding liability, cost, and other considerations related to changes to the auditor's reporting model.

### ***Liability Considerations***

We believe the concerns outlined by the PCAOB in the Concept Release related to the potential for increased litigation risk are warranted. Auditor liability has been discussed in numerous forums for decades, and we continue to believe it should be an important area for consideration by all stakeholders, including the PCAOB, as potential changes to the auditor's reporting model are evaluated.

### ***Cost Considerations***

The CAQ believes the Board should determine whether the potential benefits of receiving certain information through changes to the auditor's reporting model outweigh the associated costs. The CAQ acknowledges that alternatives presented in the Concept Release as well as the CAQ's suggested attestation report on CAEs in the MD&A will require additional audit effort and increase audit cost.

### ***Suggested PCAOB Actions to Determine if Potential Changes Meet Investor Needs***

We believe the PCAOB should consider several actions to ensure that any changes to the auditor's reporting model meet the needs of investors. First, it is important for the PCAOB to define clear objectives for any changes to the auditor's reporting model and to communicate these objectives to all stakeholders. Second, we believe the PCAOB should develop examples of how changes to the auditor's report could be incorporated (similar to the examples presented in the Concept Release) and that these examples be shared with a wide variety of investors to determine if the proposed changes will improve the usefulness of auditor reporting. Lastly, we believe the PCAOB could consider field testing as a mechanism to assess the feasibility and effectiveness of any changes prior to full-scale implementation in order to determine whether the needs of investors are being met by such changes. Without definition and communication of clear objectives, sharing of examples prior to implementation, and field testing to assess effectiveness, there is a risk that investors will remain dissatisfied despite the changes that are implemented.

### ***Preparing for Changes to the Auditor's Report***

The CAQ believes that consideration should be given to the time and effort required to prepare and educate investors and other financial statement users on any changes that are ultimately adopted in order to reduce the risk of investor misunderstanding or widening the expectation gap. For instance, the PCAOB may consider holding investor forums, similar to the small business forums currently held, to help ready the market for any changes. In addition, the PCAOB may consider implementing certain changes to the auditor's report in tranches – requiring certain changes to be adopted for audits of the largest issuers first.



## **VII. Views on Auditor Assurance on Information Presented Outside the Financial Statements**

As discussed previously, the CAQ believes that further consideration regarding auditor involvement with other information provided by management (e.g., earnings releases, non-GAAP information) is warranted, given the value that investors place on such information in making investment decisions. However, in the near term, the CAQ believes the Board should focus on improvements to the information communicated to investors through the addition of clarifying language to the standard auditor's report, a separate auditor attestation report on CAE disclosure in MD&A and/or an EOM approach.

With regard to the potential for auditor involvement with earnings releases, we note that the auditor often performs procedures on these management communications prior to public distribution to assess the consistency of the financial information contained therein with the audit in process. However, some investors may not be aware that these procedures are performed. Auditor issuance of the equivalent of an agreed-upon procedures (AUP) report for general use could potentially provide investors with added visibility in this area. Existing PCAOB standard AT 201, *Agreed-Upon Procedures Engagements*, which governs AUP reports, requires that this type of report be restricted for use by specified parties. Participants at the CAQ's RoA discussion series agreed that further auditor association with certain information communicated by management, such as earnings releases could add value, and is an area deserving of further exploration.

\*\*\*\*

The CAQ recognizes that change is needed to enhance the information communicated by the auditor and is committed to embracing responsible calls for change. We continue to believe that a holistic approach examining opportunities for improvement in the roles and responsibilities of all members of the financial reporting supply chain will best serve the interests of investors over the long term. In the near term, as a result of our examination of possible improvements to the auditor's reporting model, we believe the addition of clarifying language to the standard auditor's report, a separate auditor attestation report on CAE disclosure in the MD&A and/or an EOM approach would improve the information communicated by auditors to investors while minimizing the unintended consequences associated with other alternatives such as AD&A.

The CAQ appreciates the opportunity to comment on the Concept Release and welcomes the opportunity to respond to any questions regarding the views expressed in this letter. Further, we stand ready to assist the PCAOB staff in any way we can as potential changes to the auditor's reporting model are further evaluated.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

Attachment A – CAQ Comment Letter Dated June 28, 2011

cc: PCAOB

James R. Doty, Chairman  
Lewis H. Ferguson, Board Member  
Daniel L. Goelzer, Board Member  
Jay D. Hanson, Board Member  
Steven B. Harris, Board Member  
Martin F. Baumann, Chief Auditor

SEC

Chairman Mary L. Schapiro  
Commissioner Luis A. Aguilar  
Commissioner Troy A. Paredes  
Commissioner Elisse B. Walter  
James L. Kroeker, Chief Accountant  
Paul Beswick, Deputy Chief Accountant  
Brian T. Croteau, Deputy Chief Accountant  
Mike Starr, Deputy Chief Accountant





June 28, 2011

**EXECUTIVE DIRECTOR**

Cynthia M. Fornelli

**GOVERNING BOARD**

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Ernst & Young LLP

Vice Chair

Michele J. Hooper, President and CEO  
The Directors' Council

Vice Chair

Barry C. Melancon, President and CEO  
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Joe Adams, Managing Partner and CEO  
McGladrey & Pullen, LLP

Charles M. Allen, CEO  
Crowe Horwath LLP

Stephen Chipman, CEO and Executive Partner  
Grant Thornton LLP

Joe Echevarria, CEO  
Deloitte LLP

Harvey J. Goldschmid, Dwight Professor of Law  
Columbia University

Robert E. Moritz, Chairman and Senior Partner  
PricewaterhouseCoopers LLP

Lynn S. Paine, Professor of Business  
Administration and Senior Associate Dean,  
Director of Faculty Development  
Harvard Business School

John B. Veihmeyer, U.S. Chairman and CEO  
KPMG LLP

Jack Weisbaum, CEO  
BDO USA, LLP

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

**Re: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket No. 034***

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the concept release). This letter and enclosures represent the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

The CAQ wants to thank the PCAOB for its outreach to the profession and other stakeholders prior to publication of the June 21<sup>st</sup> concept release on the auditor's reporting model. The CAQ congratulates the PCAOB and its staff on the process and thoughtful content put forward for public consideration. In partial response to the concept release, the CAQ is

formally submitting the ideas we discussed and shared with the staff on June 9<sup>th</sup> as part of the PCAOB's outreach efforts (see enclosed illustrative example reports and accompanying letter). In addition, the CAQ will be submitting further comments on the concept release on or prior to the September 30<sup>th</sup> due date.

The auditing profession would be happy to meet with the staff to discuss the content of the illustrative example reports in greater detail, or answer any questions.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

Enclosures

cc: PCAOB  
Martin Baumann, Chief Auditor and Director of Professional Standards





June 9, 2011

**EXECUTIVE DIRECTOR**

Cynthia M. Fornelli

**GOVERNING BOARD**

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James S. Turley, Chairman and CEO  
Ernst & Young LLP

Vice Chair  
Michele J. Hooper, President and CEO  
The Directors' Council

Vice Chair  
Barry C. Melancon, President and CEO  
AICPA

Joe Adams, Managing Partner and CEO  
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Charles M. Allen, CEO  
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Stephen Chipman, CEO and Executive Partner  
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Columbia University

Robert E. Moritz, Chairman and Senior Partner  
PricewaterhouseCoopers LLP

Lynn S. Paine, Professor of Business  
Administration and Senior Associate Dean,  
Director of Faculty Development  
Harvard Business School

John B. Veihmeyer, U.S. Chairman and CEO  
KPMG LLP

Jack Weisbaum, CEO  
BDO USA, LLP

Mr. Martin Baumann  
Chief Auditor and Director of Professional Standards  
Public Company Accounting Oversight Board  
1666 K Street  
Washington, DC 20006-2803

**Re: Changes to the Auditor's Report - Model Approach for Consideration**

Dear Marty:

The Center for Audit Quality (CAQ) was formed in 2007 and is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets by fostering high quality performance by public company auditors, convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocating policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. We are a membership organization with nearly 700 public company auditing firm members that are registered with the Public Company Accounting Oversight Board (PCAOB). Our member firms are committed to the public interest role that auditors play in our markets.

As a public policy organization, we strive to assure that our efforts are infused with a public interest perspective. The members of our Governing Board (which includes the CEOs of the eight largest accounting firms, the American Institute of Certified Public Accountants, and three independent public members) have a keen understanding and appreciation of the important role the public company auditing profession has in serving the public interest and honoring the public trust. Our three independent public board members strengthen our focus on the public interest and also bring us expertise in financial reporting, securities law and corporate governance.

To realize our vision, the CAQ works with investors, academics, audit committee members, preparers, internal auditors, and policy makers to explore issues and collaborate on initiatives that can advance audit quality.

The CAQ consistently has supported the implementation of the Sarbanes-Oxley Act of 2002 and, working in collaboration with others with responsibility for financial reporting, has a number of initiatives underway to advance the deterrence and detection of financial reporting fraud. We also support research on issues relating to investor confidence, public company auditing and the capital markets in part by issuing grants that fund independent academic research. In all that we do, we are particularly interested in investors' views, as they are the ultimate users of the audited financial statements.

Recent views expressed by investors convey their need for further information on a number of different matters including, but not limited to, additional insight into accounting policies, particularly critical accounting estimates; information about the activities of public company audit committees, including discussions on critical matters with management and the external auditors; and more information about the independent audit.

In response to these calls for change, the PCAOB announced a standard-setting initiative focused on possible changes to the auditor's reporting model. The profession also recognizes that change is needed, is prepared to embrace the responsible calls for change in this area, and believes that a holistic approach where all stakeholders agree on a way forward will best serve investors and is a requirement if such change is to be meaningful. In this regard, the CAQ established a working group in 2010, comprised of members of the profession, to consider how to best serve investors given their information needs as we understand them.

The working group explored a variety of possible alternatives for communicating additional information about the audit, including changes to the auditor's report combined with expanded management disclosures and audit committee reporting to shareholders with corresponding auditor association. Members of this working group met with you and your staff on February 7, 2011 to discuss these possible alternatives, which were also the subject of my February 11, 2011 letter. CAQ member firm representatives have also participated in recent Standing Advisory Group discussions on this important topic.

Subsequent to our meeting on February 7, 2011, the PCAOB staff identified a number of possible changes to the auditor's reporting model under current consideration. In line with your efforts to identify changes that are both responsive to the needs of investors and can be practicably implemented, the CAQ working group has developed a model approach, described below for your consideration. The model provides examples of potential revisions to the auditor's reporting model that we believe: (i) are responsive to many of the information needs we have heard from investors (ii) can be practicably implemented in a relatively short time frame and (iii) are consistent with the overarching principles discussed with you at our February meeting and outlined below.

In presenting this potential reporting model for your consideration, we recognize that refinements in the actual language used may be necessary to align with other PCAOB professional standards, and that implementation guidance will need to be developed to address some of the concepts included in the model, such as the communication of component auditors and the "areas of audit emphasis" section.

### ***Overarching Principles***

In evaluating this topic, the CAQ working group established the following overarching principles, with investors in mind, to guide the development of possible areas for further consideration related to revisions to the auditor's reporting model:

- Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.
- Any changes to the reporting model need to enhance, or at least maintain, audit quality.
- Any changes to the reporting model should narrow, or at least not expand, the expectations gap.
- Any changes to the reporting model should add value and not create investor confusion. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.
- Auditor reporting should focus on the objective rather than the subjective.

Conceptually, we understand the suggestion that an auditor deliver to investors the same information that is provided to the issuer's audit committee. However, it is important to understand (as is made clear in the PCAOB's proposed auditing standard on this topic) that such communication is prepared with the expectation that a dynamic two-way discussion between the auditor and audit committee will occur and that questions will arise and additional context and perspectives will be communicated during the course of this discussion. Such interaction can often clarify the specific points raised, particularly around certain accounting and financial reporting matters involving a high degree of subjectivity. This important two-way dialogue will not take place in connection with the general distribution of a report. Additionally, the audit committee obtains insight by virtue of its financial reporting oversight responsibilities which provide additional context for such communications from the auditor. Consequently, we believe that providing investors with the same information that is provided to the audit committee, without the context obtained from a two-way dialogue may be incomplete, generate greater confusion and not enhance the overall understanding of the readers of such a report.

### ***Illustration of a Potential Approach***

After evaluating various alternatives, the CAQ working group determined that the following approach would improve the auditor reporting framework, would help serve the interests of investors, and could be pragmatically implemented in relatively short-order. We recognize this is but one approach and there may be others that meet the objectives we have outlined above. In addition, while we have illustrated the approach in three separate reports; the reports could be combined.



1. Amend the standard financial statement audit report to include the following:
  - a. Explicitly identify that the footnotes are an integral part of the financial statements and are covered by the audit report (highlighted in the scope section)
  - b. Identify that the auditor is independent under all relevant U.S. Securities and Exchange Commission (SEC) and PCAOB standards
  - c. Where applicable, describe the accounting firm network structure, the responsibility of the member firm signing the audit report, and the participation of other member firms in the audits
  - d. Provide an expanded discussion covering management and audit committee responsibilities for the financial statements and the Form 10-K
  - e. Highlight that the auditor is responsible for planning and performing the audit to obtain reasonable assurance that the financial statements, taken as a whole, are free of material misstatement, “whether due to error or fraud”
  - f. Identify what is meant by the term “reasonable assurance,” “material misstatement,” and the approach used by the auditor to assess “materiality”
  - g. Highlight the necessity of using professional judgment in making audit risk assessments and in the selection of audit procedures and the consideration the auditor gives to the issuer’s internal control over financial reporting when making such determinations
  - h. Outline the auditor’s responsibility in the event a conclusion is reached that the financial statements are not in accordance with Generally Accepted Accounting Principles or in situations where the audit scope has been limited
  - i. Describe the auditor’s responsibility for information outside of the financial statements (including Management’s Discussion & Analysis (MD&A))
  - j. Address the audit report to the shareholders of the company in addition to the Board of Directors
  - k. Include a reference and link to where more information about public company audits and auditors can be found. For purposes of the illustrative reports attached, we have utilized as an example of this approach the *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*, published by the CAQ and available on our website.

We have illustrated in Example A, attached to this letter, how the above suggestions would revise the current financial statement audit report. We believe these changes are responsive to many of the comments that have been raised.

2. Using an emphasis-of-matter like approach, the audit report would identify specific topics or events, unusual transactions or other matters that were viewed to be areas of audit emphasis by the auditor. Consistent with the overarching principles, we believe these descriptions should be objective, fact-based discussions and make specific reference to where such items appear in the financial statements. We have illustrated in Example A how this approach might look in practice. We believe this approach responds to the request that the auditor indicate areas of audit emphasis, and directs the user to where such matters are discussed in the financial statements. As noted above, we recognize that standard-setting activity and resulting implementation guidance will be necessary to help guide the auditor in assessing and consistently determining the type of

matters that should be identified in this section of the revised report, and the extent of the auditor's discussion relating to such matters.

3. Prepare a new report on the examination of the issuer's Critical Accounting Estimates disclosure in its MD&A. We have illustrated this new report in Example B attached to this letter. We believe auditor attestation will serve to continue to improve disclosures in this important area and will be responsive to the various suggestions that have been raised with respect to the need for more emphasis on the important judgment calls made in preparing the financial statements. The SEC would likely need to amend Regulation S-X to require this new report. Likewise, MD&A would need to clearly identify the Critical Accounting Estimates section that will be covered by the examination report. This may also likely require some SEC amendments, but we believe such changes should not be complex or time-consuming. (We note that Example B may also be written to include language from Example A, for example, language relating to the performance of procedures by member firms.)
4. Amend the standard audit report on internal control over financial reporting to reflect many of the changes outlined in 1. above. We have illustrated in Example C attached to this letter how these suggestions would change the present internal control over financial reporting audit report. We believe these changes are responsive to many of the comments that have been raised. (We note again that this Example C may also be written to include additional language from Example A, such as member firm considerations, when appropriate.)

While we have included in our model both an emphasis-of-matter like approach for specific areas of audit emphasis to be included in the financial statement auditor's report, and a separate examination report on the Critical Accounting Estimates disclosure, we appreciate that both of these enhancements may not be necessary. While we believe that the examination report is the enhancement most likely to address investor's needs, we recognize that each of these enhancements or a combination of the two has merit for consideration.

### ***Other Thoughts***

We also believe that an expanded audit committee report, which includes matters discussed with the auditor that the audit committee considered significant in discharging its responsibilities, accompanied by auditor association therewith, is worthy of further consideration as another means of providing additional information called for by certain investors. We continue to give thought to this idea, and would be pleased to collaborate with the PCAOB, SEC and others (importantly, representatives from the audit committee community) on the further consideration of this concept.

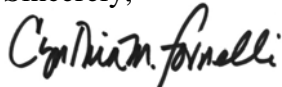
In connection with the potential expansion of the auditor's reporting model, we continue to have concerns about increasing the profession's liability risks. This is, of course, a matter that has been discussed in numerous forums for many decades, but we believe it would be a necessary component on any proposal for revised auditor reporting.



We appreciate the opportunity to share our views regarding possible revisions to the auditor's reporting model. We understand the PCAOB is working toward the issuance of a concept release on this topic by the end of June, and we look forward to reviewing and commenting on that document. At the same time, we want to go on record that we are fully committed to making progress and stand ready to embrace calls for responsible change in this important area. We sincerely believe the approach outlined above serves these purposes, will help serve investors, and can be implemented in a relatively quick time frame.

We also welcome the opportunity to work with the PCAOB staff following the issuance of the concept release and in your further evaluation of the auditor's reporting model. We stand ready to assist you in any way we can, including participation in any meetings or roundtables you are planning.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

cc: PCAOB

James R. Doty, Chairman  
Lewis H. Ferguson, Member  
Daniel L. Goelzer, Member  
Jay D. Hanson, Member  
Steven B. Harris, Member

SEC

James L. Kroeker, Chief Accountant  
Paul A. Beswick, Deputy Chief Accountant  
Brian T. Croteau, Deputy Chief Accountant  
J.W. Mike Starr, Deputy Chief Accountant



## Example A

### Revised Auditor's Report on the Financial Statements with Reference to Separate ICFR and Critical Accounting Estimates Reports

#### Report of Independent Registered Public Accounting Firm on the Consolidated Financial Statements of Sample Company

To the Board of Directors and Shareholders of Sample Company

We have audited the accompanying consolidated balance sheets of Sample Company and subsidiaries (the Company) as of December 31, 201Y and 201X, the consolidated statements of income, stockholders' equity, comprehensive income and cash flows for each year in the three year period ended December 31, 201Y, and the related notes to the consolidated financial statements for all periods presented (collectively referred to below as the "consolidated financial statements").

We are an independent registered public accounting firm with respect to the Company within the meaning of the Securities Act of 1933 and the applicable rules and regulations thereunder adopted by the United States Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (United States) (PCAOB). XYZ LLP is the principal auditor for the Company for the periods cited above. XYZ LLP is the US member firm of XYZ Limited, a global network of affiliated auditing firms. [Each member firm in the network is a separate legal entity, and all member firms follow a common audit methodology and consistent quality control policies.]<sup>1</sup> Certain network member firms participated in our audits of the Company and such participation, in the aggregate, covered approximately Y% and X% of the Company's consolidated assets as of December 31, 201Y and 201X and approximately X%, Y% and Z% of the Company's consolidated revenues for each year in the three year period ended December 31, 201Y. We (XYZ LLP) take responsibility for the work performed by our member firms in connection with our audits.

#### **Management and Audit Committee Responsibilities for the Financial Statements and Other Information**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), and for establishing and maintaining adequate internal control over financial reporting to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to error or fraud.

Management is also responsible for the preparation and presentation of the Company's Annual Report on Form 10-K in accordance with the rules and regulations of the SEC, including

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<sup>1</sup> Each firm would describe their member network affiliation.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) appearing in Item 7 of the Annual Report.

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

### **Auditor Responsibility for the Audit of the Financial Statements**

Our responsibility is to express an opinion on these consolidated financial statements, taken as a whole, based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement, whether due to error or fraud. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit conducted in accordance with PCAOB standards may not always detect a material misstatement. Our judgments about materiality are affected by our understanding of the financial information needs of investors and other users of the consolidated financial statements. A material misstatement represents an omission or misstatement that would be viewed by a reasonable investor as having significantly altered the 'total mix' of information presented in the consolidated financial statements, taken as a whole.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. In the course of completing our audit, the audit evidence we obtain is often persuasive rather than conclusive. The procedures selected for performance depend on our judgment, including our assessment of the risks of material misstatement of the consolidated financial statements, whether due to error or fraud. In making those risk assessments, we consider internal controls relevant to the Company's preparation and fair presentation of the consolidated financial statements in accordance with U.S. GAAP in order to design audit procedures that we believe are appropriate in the circumstances. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and related financial statement disclosures. Our audits also included such other procedures as we considered necessary in the circumstances.<sup>2</sup>

PCAOB standards require that we modify our report if we determine that the consolidated financial statements are materially misstated. If there are significant restrictions placed on the scope of our audit PCAOB standards prohibit us from expressing an opinion on the financial statements.

We believe that the procedures performed and the audit evidence obtained provides a reasonable basis for our opinion.

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<sup>2</sup> Additional information about public company audits and auditors can be found in the *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*, published by the Center for Audit Quality and available on the organization's website at [http://www.thecaq.org/publications/In-Depth\\_GuidetoPublicCompanyAuditing.pdf](http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf).



## **Auditor Responsibility for Other Information Presented Outside of the Financial Statements**

We have separately examined the Critical Accounting Estimates disclosure included as part of MD&A in the Company's December 201Y Annual Report on Form 10-K. Our responsibility with respect to all other information presented outside of the consolidated financial statements (including all other sections of the MD&A) is to read this other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements. We are required to follow up on any material inconsistencies and material misstatements of fact of which the auditor becomes aware with management, and with the Audit Committee if necessary, until properly resolved, but are not otherwise required to express an opinion on the other information, including all other sections of MD&A. Other than where identified in this report, our responsibility with respect to the other information in the Form 10-K does not extend beyond the financial information identified in our report, and we have no obligation to perform any procedures to corroborate information presented outside of the consolidated financial statements.

## **Opinion on the Consolidated Financial Statements**

In our opinion, the consolidated financial statements, taken as a whole, present fairly, in all material respects, the consolidated financial position of Sample Company and subsidiaries as of December 31, 201Y and 201X, and the consolidated results of their operations and cash flows for each year in the three year period ended December 31, 201Y, in conformity with U.S. GAAP.

## **Areas of Audit Emphasis**

In connection with our audits, we also bring to your attention the matters listed below. This is not intended to be a complete list of all areas that our audit procedures addressed in response to identified risks of material misstatement.

1. In December of 201Y, the Company completed the acquisition of ABC Company. As of December 31, 201Y, the Company has completed the allocation of the purchase price on a preliminary basis, assigning approximately \$XXX million to goodwill and other intangible assets with indefinite lives. The Company will finalize the purchase price allocation during 201Z, and the amounts assigned as of December 31, 201Y could change. See Note B for further details.
2. In connection with the financing required to complete the ABC acquisition, the Company borrowed \$XXX million from a consortium of banks. The borrowing has a maturity date of March 31, 201A, or fifteen months from the date of the balance sheet. As of December 31, 201Y, the borrowing is classified as long-term debt, since it has a maturity date beyond the end of the 201Z fiscal year. The Company is in the process of exploring alternatives to refinance this borrowing on a longer-term basis. See Note D for further details.
3. The Company provides financing to certain customers of its [Example Segment]. Business conditions in this Segment led to a slow-down in collections and an increase in potential uncollectible balances. At December 31, 201Y, the gross financing balance

approximated \$X,XXX million and the Company maintained a reserve for uncollectible accounts of \$XXX million. The balance of accounts that were 90 or more days past due at that date approximated \$XX million. This compares to a gross financing balance, reserve for uncollectible accounts and amounts 90 or more days past due of \$X,XXX million, \$XXX million and \$XX million at December 31, 201X respectively. The net expense recorded for estimated uncollectible amounts approximated \$XXX million during 201Y. See Note E for further details.

4. The Company has goodwill of \$X,XXX attributable to its [Example Segment] reporting unit as of December 31, 201Y. The Company performed its annual impairment testing as of October 31, 201Y. No impairment was recognized because the Company's estimated fair value of this reporting unit exceeded its carrying value at that date; however, the comparison was close and a further decline in the fair value of this reporting unit could give rise to an impairment of the goodwill balance in the future. See Note H for further details.
5. The Company is exposed to various claims and contingencies in the normal course of business. We note two significant matters outstanding as of December 31, 201Y. The Company is a defendant in litigation involving a patent claim that has been ongoing for several years. The Company is also liable for the costs of remediating an environmental claim relating to a business that was sold in 201X. See Note J for further details surrounding these matters.

We highlight the above matters because they represent some of the areas of audit emphasis during the periods covered by our report. Our audits included performing procedures designed to address the risks of material misstatement associated with the above matters. Such procedures were designed in the context of our audit of the consolidated financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures. As noted above, our audits also included procedures in response to identified risks and those required by professional standards that have not been specifically identified herein.

### **Other Reports**

We also have examined, in accordance with the standards of the PCAOB, Sample Company's Critical Accounting Estimates disclosure included as a part of MD&A in the Company's December 31, 201Y Annual Report on Form 10-K, and our report dated [date] expressed an unqualified opinion that the Company's presentation of the Critical Accounting Estimates disclosure includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; that the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and that the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

In addition, we have audited, in accordance with the standards of the PCAOB, Sample Company's internal control over financial reporting as of December 31, 201Y, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated [date] expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

XYZ LLP

[City, State]  
[Date]

**Example B****New Report on Critical Accounting Estimates****Report of Independent Registered Public Accounting Firm on the Critical Accounting Estimates Disclosure of Sample Company**

To the Board of Directors and Shareholders of Sample Company

We have examined the Critical Accounting Estimates disclosure of Sample Company and subsidiaries (the Company) included as a part of the Company's Management's Discussion and Analysis (MD&A) that is included in the Company's December 31, 201Y Annual Report on Form 10-K.

**Nature of the Critical Accounting Estimates Disclosure**

The Critical Accounting Estimates disclosure is designed to present the Company's analysis of the uncertainties involved in applying its adopted accounting principles and policies at a given time or the variability that is reasonably likely to result from its application over time. The subjectivity of these disclosures is influenced by the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with such assumptions. Consequently, actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

**Management and Audit Committee Responsibilities for the Critical Accounting Estimates Disclosure**

Management is responsible for the preparation of the Company's Critical Accounting Estimates disclosure pursuant to the rules and regulations adopted by the U.S. Securities and Exchange Commission (SEC), and for such disclosure controls and procedures designed to ensure that information required to be disclosed pursuant to the securities laws is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. The preparation of the Critical Accounting Estimates disclosure requires management to interpret the criteria for disclosure, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information.

The Company's audit committee oversees the financial reporting process (including the Company's Critical Accounting Estimates disclosure) and its disclosure controls and procedures (which include internal control over financial reporting), areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Examination of the Critical Accounting Estimates Disclosure**

Our responsibility is to express an opinion on the Critical Accounting Estimates disclosure presentation based on our examination. Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB) and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and other information disclosed in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that the procedures performed and the examination evidence obtained provides a reasonable basis for our opinion. In forming our opinion, we exercised professional judgment in evaluating the reasonableness of the disclosures based on information that was available at the time of our examination. In the course of completing our examination, the evidence we obtain is often persuasive rather than conclusive.

**Opinion on the Critical Accounting Estimates**

In our opinion, the Company's presentation of the Critical Accounting Estimates disclosure referred to above includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's consolidated financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

**Other Report**

We have audited, in accordance with the standards of the PCAOB, the consolidated financial statements of Sample Company and subsidiaries as of December 31, 201Y and 201X, and for each of the years in the three-year period ended December 31, 201Y, and in our report dated [date], we expressed an unqualified opinion on those consolidated financial statements.

XYZ LLP

[City, State]

[Date]

**Example C****Revised Report on Internal Control over Financial Reporting****Report of Independent Registered Public Accounting Firm on Sample Company's Internal Control over Financial Reporting**

To the Board of Directors and Shareholders of Sample Company

We have audited Sample Company's (the Company) internal control over financial reporting as of December 31, 201Y, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

**Management and Audit Committee Responsibilities for Internal Control over Financial Reporting**

Sample Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying [title of management's report].

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Audit of Internal Control over Financial Reporting**

Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit of internal control over financial reporting conducted in accordance with PCAOB standards may not always detect a material weakness. Our judgments about materiality are affected by our understanding of the financial information needs of users of this Report. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, giving rise to a reasonable possibility that a material misstatement of the Company's annual or interim financial results will not be prevented or detected by the Company on a timely basis. If one or more material weaknesses exist, the Company's internal control over financial reporting cannot be considered effective, and we are required to include in our report an opinion that the Company's internal control over financial reporting is not effective. If there are restrictions placed on the scope of our audit, we are prohibited from expressing an opinion on the effectiveness of the Company's internal control over financial reporting.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating

effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

We believe that the procedures performed and audit evidence obtained provides a reasonable basis for our opinion.

### **Definition and Limitations of Internal Control over Financial Reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

### **Opinion on Internal Control over Financial Reporting**

In our opinion, Sample Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 201Y, based on the criteria established in *Internal Control – Integrated Framework* issued by COSO.

### **Other Report**

We have audited in accordance with the standards of the PCAOB, the consolidated financial statements of Sample Company and subsidiaries as of December 31, 201Y and 201X, and for each of the years in the three-year period ended December 31, 201Y, and in our report dated [date], we expressed an unqualified opinion on those consolidated financial statements.

XYZ LLP

[City, State]

[Date]