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December 11, 2013

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

via email to comments@pcaobus.org

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

Dear Ms. Brown:

We appreciate the opportunity to comment on two auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "**Auditor Reporting Standard**") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "**Other Information Standard**"), proposed by the Public Company Accounting Oversight Board on August 13, 2013 in PCAOB Release No. 2013-005 (the "**Proposing Release**").

The Board's goal is to "increase the informational value of the auditor's report."[1] This is not a controversial objective, but we believe that the costs of implementing these specific proposals, to be borne by public companies and their investors, would substantially outweigh their benefits to investors and the public. As a result we question whether the Securities and Exchange Commission would be able to approve the proposals were they adopted by the Board. As former Commissioner Paredes observed in 2012:

> "[T]he PCAOB . . . needs to engage in rigorous cost-benefit analysis of its rules, including its auditing standards. We need to be assured that the potential consequences – both for better and for worse – of a PCAOB rule have been thoroughly evaluated and considered in a balanced way. Otherwise, for example, how can we determine on a reasoned basis whether a PCAOB proposal advances the public interest? Whether a PCAOB rule advances the public interest depends on its practical impacts. Cost-benefit analysis allows us to better

[1] Proposing Release at 5.

> anticipate and assess these impacts so that a well-reasoned judgment can be made."[2]

As discussed below, we believe that a thorough analysis would show the costs of the proposals difficult to justify compared to their anticipated benefits. More fundamentally, we believe that if additional information for investors is the goal, the company itself should be the source of that information, rather than a third party whose expertise lies not in communicating with the marketplace, but in assessing whether the company's financial statements are presented in accordance with generally accepted accounting principles.

Auditor Reporting Standard

The proposed Auditor Reporting Standard requires the auditor's report to include a discussion of "critical audit matters," defined as "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements."[3] The disclosure would include identification of the critical audit matters, a description of the considerations that resulted in the determination that a critical audit matter existed, and reference to the relevant financial statement accounts and disclosures that relate to the critical audit matters.[4]

The Proposing Release indicates that critical audit matters could be derived from issues currently identified in the engagement completion document, issues reviewed by the engagement quality reviewer, issues communicated to the audit committee, or any combination of the three.[5] Although the Proposing Release does not mention it, critical audit matters would almost certainly include all of a company's "critical accounting policies," which Section 204 of the Sarbanes-Oxley Act of 2002 requires auditors to report to the audit committee and which U.S. public companies disclose as part of Management's Discussion and Analysis in the Annual Report on Form 10-K.[6]

The auditor's discussion of critical audit matters would not occur in a risk-free vacuum. Although the language in the proposed Auditor Reporting Standard focuses the need for disclosure on only the *most difficult* matters, auditors would be heavily incentivized to include *all* matters identified in the engagement completion document, *all* issues reviewed by the engagement quality reviewer, and *all* significant issues communicated to the audit committee regarding the audit, including the company's critical accounting policies. The Proposing Release states that "[t]he Board would not expect that each matter included in any one or more of these sources would be a critical audit matter,"[7] but this ignores the reality that auditors are at risk of being sued on the basis of their report, including the critical audit matters discussion, in the event of a subsequent financial restatement or other financial difficulties at the audit client. This fact alone virtually guarantees

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[2] Remarks of SEC Commissioner Troy A. Paredes at AICPA Council Spring Meeting, Washington, DC (May 17, 2012) (*available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171490500).

[3] Proposing Release at 15.

[4] Proposing Release at 16.

[5] Proposing Release at 15.

[6] Critical accounting policies consist of accounting policies that "are both most important to the portrayal of the company's financial condition and results, and . . . require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain." *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, SEC Rel. No. 33-8040 (Dec. 12, 2001).

[7] Proposing Release at 15.

that any discussion of critical audit matters will be a lengthy affair, because auditors will not want to be second-guessed in litigation about, for example, why some matters discussed with the audit committee were disclosed as critical audit matters while others were not. As a result we would expect the "critical audit matters" discussion to cover, for example, all matters that the engagement team discussed with their national office,[8] all matters on which the company may have consulted with the SEC or other regulatory agencies and all material weaknesses (and likely some significant deficiencies) in internal controls that were identified in the course of the audit, in addition to all critical accounting policies already discussed in the annual report. Because the discussion would appear in the company's own filings and express judgments about the company as well as provide a basis for liability against the company, we believe companies would insist on reviewing, potentially negotiating and approving all critical audit matters before finalizing the audit.

At the same time, because the engagement team will recognize that communications with the national office or with the audit committee will likely trigger a need for critical audit matter disclosure, we believe that a requirement to discuss critical audit matters in the audit report will invariably have a chilling effect on these discussions. It goes without saying that inhibiting communications between the auditor and the audit committee, or inhibiting the auditor's own internal discussions, will not have a healthy impact on the quality of public company financial reporting. Existing auditing standards promote an open dialogue between auditors and audit committees precisely because this communication results in better disclosure.[9]

The illustrative disclosure contained in the Proposing Release ranges from several paragraphs to more than a page of additional language for each critical audit matter.[10] This range multiplied by the number of critical audit matters a company is likely to have would dramatically lengthen the audit report. Because critical audit matters are expected to be subjective and variable among companies,[11] it will also be difficult or impossible for investors to compare one company's critical audit matters to another's. The sheer volume of critical audit matters, as well as the lack of comparability across companies even in the same industry, would undermine the benefits of the audit report's current pass/fail model, which the Proposing Release acknowledges enjoys investor support "because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented."[12]

Given the length and scope of a company's critical audit matters, the effort to analyze, draft and negotiate them would be substantial, would raise costs and would increase pressure on management, audit committees and auditors during already-hectic annual reporting periods. We therefore question the Proposing Release's assertion that developing critical audit matters

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[8] Auditing Standard No. 16, *Communications with Audit Committees*, states that "the auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process."

[9] "The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors." PCAOB Rel. No. 2012-004 at 2-3 (Aug. 15, 2012).

[10] Proposing Release app. 5 at A5-65-78.

[11] "The communication of critical audit matters would result in differences among auditors' reports. For instance, the communication of critical audit matters is intended to be tailored to the audit of the company; therefore, auditors' reports are not expected to be comparable from one auditor's report to the next." Proposing Release app. 5 at A5-41-42.

[12] Proposing Release app. 5 at A5-5.

disclosure would not be unduly burdensome,[13] and find it at odds with its description of the process involved – which includes the attention of the senior members of engagement teams; the attention of the engagement quality reviewer; consultations with others, including the auditor's national office; and discussions with management or the audit committee.[14]

For all of the effort that the proposed requirement would entail, we wonder what the benefits to investors would be. To the extent critical audit matters merely echo the company's critical accounting policies already disclosed, the informational value would be minimal or non-existent. To the extent they summarize matters on which the engagement team needed to consult with their national office, they may be saying more about the experience of the individual auditors than the quality of the company's financial disclosures. To the extent they recap significant deficiencies or material weaknesses discussed with the audit committee, they would either be repeating information the company is already required to disclose, or information the SEC has already determined companies need not automatically disclose.[15]

We expect that the number of critical audit matters included in audit reports will only proliferate over time, exactly as experience has shown with respect to risk factor disclosure in public filings with the SEC. The inclusion of critical audit matters in audit reports will likely be seen to provide protection to auditors in the same manner risk factors are thought to provide protection to companies. It is hard to imagine that lawyers for auditors will not advise that the inclusion of more (rather than fewer) critical audit matters, together with a thorough and detailed discussion of each, would better serve to protect auditors from legal risk. If any auditor includes a critical audit matter with respect to a company in a particular industry, other auditors will be incentivized to include a comparable critical audit matter to avoid the litigation risk of having a less complete discussion.

The proposed Auditor Reporting Standard appears to be significantly driven by the belief that it could "alleviate the information asymmetry that exists between company management and investors"[16] and that investors want "more information." We do not believe these very general goals provide an adequate rationale for the dramatic expansion of the audit report with its increased costs, almost inevitable delays and potentially serious unintended consequences with respect to communication and consultation. If more disclosure is in fact necessary, it should be specifically identified and required to be provided by the company. The auditor's role as an independent third party should remain one of oversight.[17]

[13] Proposing Release app. 5 at A5-22.

[14] Proposing Release app. 5 at A5-37.

[15] Although companies are required to disclose material weaknesses in internal controls, they are not generally required to disclose significant deficiencies. *See* SEC, *Frequently Asked Questions, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, question 11 (Oct. 6, 2004) (*available at* http://www.sec.gov/info/accountants/controlfaq1004.htm).

[16] Proposing Release at 6.

[17] As Board member Jay D. Hanson noted at the Board's open meeting on June 21, 2011, "[A]uditors are not analysts or investment advisers. They are not trained to evaluate and communicate the overall business and strategic risks of the companies they audit." (a*vailable at* http://pcaobus.org/News/Speech/Pages/06212011_HansonStatement.aspx).

Other Information Standard

The proposed Other Information Standard requires the auditor to communicate its responsibilities for and conclusions with respect to "other information."[18] For a U.S. public company, this includes all information in its Annual Report on Form 10-K other than the audited financial statements and accompanying report.[19] Where the auditor does not identify a material inconsistency or material misstatement of fact in the "other information," the following language would appear in the auditor's report:

> "Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information."[20]

The proposed Other Information Standard differs from the existing standard, AU Section 550, *Other Information in Documents Containing Audited Financial Statements*, in both scope and substance [21] and would significantly expand the auditor's responsibilities with respect to "other information." The current standard provides that the auditor "should read the 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 financial statements."[22] It also explicitly provides that the auditor's responsibility is limited to financial information identified in its report.[23]

By contrast, the proposed Other Information Standard requires the auditor to evaluate "other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit."[24] The auditor would need to perform "additional procedures, as necessary" to determine whether there is a material inconsistency or misstatement of fact in the "other information."[25] If the auditor identifies a material inconsistency or misstatement of fact, the auditor must request management to revise the "other information;" if management does not, the auditor may be required to contact the audit committee, consider resignation, withhold the audit report, or notify the appropriate regulator.[26]

Before proposal of the Other Information Standard, we believe it was generally agreed that auditors lack the necessary professional training, expertise and evidence to comment affirmatively on all "other information" in a company's annual report. In fact, the current standard

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[18] Proposing Release app. 2 at A2-2-3.

[19] Id.

[20] Proposing Release app. 1 at A1-16.

[21] The existing standard and the proposal each provide that "other information" includes information, other than the audited financial statements and the related auditor's report, contained in a public company's annual report. The proposed Other Information Standard also covers information about executive compensation and corporate governance, typically contained in the company's proxy statement, which is often filed with the SEC several weeks after the audit report is issued. Proposing Release app. 2 at A2-2.

[22] AU § 550.04.

[23] Id.

[24] Proposing Release app. 2 at A2-3.

[25] Proposing Release app. 2 at A2-4.

[26] Proposing Release app. 2 at A2-4-5.

instructs that when an auditor encounters a potential misstatement or inconsistency, "the auditor should consider that he may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion."[27] Similarly, AU Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, cautions that in obtaining information regarding litigation, claims and assessments, the auditor "ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments."[28]

In preparing the "other information" in its annual report, the company is required to make numerous judgments, often of an explicitly "legal" character. One of the most frequent of these is to assess the "materiality" of information that may not be financial in nature. "Materiality," like the term "material," is not defined in the U.S. federal securities laws (or in authoritative accounting literature) but instead is expounded in numerous judicial decisions, including the U.S. Supreme Court's opinion in *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976):

> "What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

Given the complexity of the relevant legal standard, companies typically make materiality judgments in close consultation with their internal and external legal advisers. The proposed Other Information Standard would, however, expressly require the auditor to make these judgments relating to information that is wholly or partly non-financial in character.

For example, a company is required to describe in its annual report development-stage products that are "material" to it;[29] the company's competitive position in its markets, if "material;"[30] and the location and general character of its principal plants, mines and other "materially important" physical properties;[31] and to file as exhibits to the annual report its "material" contracts.[32] Audit evidence will frequently exist about a new product (research and development expenditures), the company's competitive position in a particular market (evidence of increasing or decreasing sales to a customer) or a particular physical asset (lease payments), but the company may choose not to discuss the particular product, competitive dynamic or physical asset in its annual report. Likewise the auditor may have access to volumes of contracts that are not filed as exhibits to the annual report. If any of these things were "material" to the company, the absence of disclosure would point to a "material inconsistency" between the audit evidence and the "other information." What professional training enables the auditor to satisfy himself that the undisclosed product,

[27] AU § 550.05.

[28] AU § 337.06.

[29] SEC Regulation S-K, Item 101(c)(1)(ii).

[30] SEC Regulation S-K, Item 101(c)(1)(x).

[31] SEC Regulation S-K, Item 102.

[32] SEC Regulation S-K, Item 601(b)(10).

competitive dynamic, physical asset or contract is not somehow material to the company? The proposed standard does not say that the auditor can defer to the judgment of company management or its counsel on questions like this – actually, it would run contrary to the principle of an independent audit if the auditor could substitute management's assertions for the auditor's professional judgment. Will the auditor need to engage its own counsel for advice? This seems likely given the expertise required, and this additional expertise will come at a cost.

At the same time auditors are tasked with passing on matters outside the scope of their professional expertise, they will face a broader scope of liability under the proposed Other Information Standard than they currently do. The auditor's statement about the accuracy of "other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit" would be included in the audit opinion and therefore would be relied upon by the investing public and available in investor litigation.[33]

Given the risk of litigation against auditors if a material inconsistency or misstatement subsequently arises, it is not realistic to expect that auditors would make the sweeping statement contemplated by the proposed Other Information Standard without substantially expanding the scope of the audit and enlisting the help of lawyers and other professional advisers with training and expertise that auditors lack. We therefore believe the Board underestimates the incentives auditors will have to augment their procedures in order to comply with the proposed Other Information Standard, thereby increasing both the cost and the lead time for audits under already-accelerated deadlines for annual filings.

We also do not believe that investors will have any appreciation as to which items of "other information" an auditor obtains relevant audit evidence and reaches conclusions during the audit, which is the stated basis of the auditor's evaluation. As a result, investors may be led to believe that the auditor's evaluation covers much more "other information" than it actually does, while at the same time leaving the auditor exposed to claims that it did or should have obtained such evidence or reached such conclusions.

We do not believe these additional costs in both money and time can be justified as being needed to ensure the absence of material misstatements and omissions in the annual report. We believe that the Board has not taken adequate account of the range of safeguards developed or strengthened since passage of the Sarbanes-Oxley Act of 2002 to achieve the same goal, including:

- Certifications required for each annual report and each Quarterly Report on Form 10-Q by Sections 302 and 906 of the Sarbanes-Oxley Act and SEC Rules 13a-14(a) and 15d-14(a), which among other things require a company's CEO and CFO to personally certify that the report "does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading." These certifications cover all "other information" in a company's annual report. Following promulgation of the Sarbanes-Oxley certification requirements, we believe most public companies significantly strengthened their internal processes in order to support the

[33] "In order to promote consistency in the addressees included in the auditor's report, the Board is proposing to require the auditor's report be addressed to investors in the company." Proposing Release app. 5 at A5-9.

required CEO and CFO certifications, by creating disclosure committees and by instituting “upward certification” procedures, for example.

- The requirement under SEC Rules 13a-15 and 15d-15 that each public company maintain and regularly evaluate the effectiveness of “disclosure controls and procedures” that are “designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Securities Exchange Act of 1934] is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms.” A company’s disclosure controls and procedures cover all “other information” contained in its annual report. In combination with the Sarbanes-Oxley certification requirements, in our experience the requirement that public companies maintain and evaluate the effectiveness of their disclosure controls and procedures has significantly increased the amount of management and audit committee attention focused on companies’ annual reports and other SEC filings, minimizing the risk of error in “other information.”

- The requirement for auditors to evaluate the effectiveness of a company’s internal controls provides further assurance of the material accuracy of information contained in filings by companies subject to Sarbanes-Oxley Section 404(b).

- Disclosures in the annual report are also subject to review and oversight by a company’s audit committee and board of directors.

While there may be some incremental value in a third party’s evaluation of “other information,” the benefits would be marginal given the extensive procedures that are already in place to ensure the consistency and accuracy of this information. We do not believe these benefits would justify the costs of introducing new and additional procedures by the auditor at the tail end of an already time-compressed process.

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For the reasons discussed above, we believe that the anticipated benefits of the proposals do not justify the related costs, and we urge the Board to reconsider its proposals in light of these concerns.

We appreciate the opportunity to comment and would be pleased to discuss any questions the Board or its Staff may have. You may contact Joseph A. Hall, Michael Kaplan, Richard J. Sandler, Richard D. Truesdell, Jr. or Sarah Ashfaq of Davis Polk at 212-450-4000.

Very truly yours,

Davis Polk & Wardwell LLP