

Ernst & Young LLP 5 Times Square New York, NY 10036 Tel: +1 212 773 3000

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

18 December 2013

# Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments, PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown:

Ernst & Young LLP (Ernst & Young) is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (Proposed Reporting Standard), The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (Proposed Other Information Standard), and the Related Amendments to PCAOB Standards (collectively, the Proposal).

We support the PCAOB's efforts to examine the adequacy of the existing auditor's reporting model and believe that, in general, the types of changes contemplated in the Proposal will improve and increase the informational value of the audit report.

We also appreciate that the Board is considering the work of other standard setters such as the International Auditing and Assurance Standards Board (IAASB) and the United Kingdom's Financial Reporting Council on this important topic. We believe the effort by the Board to work closely with these standard setters to harmonize auditor reporting, where possible, and minimize potential complexity for users of financial statements is commendable.

While we are supportive of the Board's overall efforts relating to the auditor's reporting model, we also believe that certain elements of the Proposal present challenges that may give rise to significant application difficulties in practice. We propose changes to address these concerns in support of the Board's objective to enhance the auditor's reporting model. We refer the Board to the comment letter on the Proposal from the Center for Audit Quality (CAQ), which identifies a number of these challenges and provides suggestions of how to address them. The CAQ's letter addresses the following areas of the Proposal:

- Critical audit matters (CAMs)
- Other information accompanying audited financial statements



- Auditor tenure
- Auditor's unqualified report and clarifying language changes
- Other considerations
  - Applicability
  - Legal considerations

We share the CAQ's concerns and support the suggestions outlined to address them, as discussed and further supplemented below. We have also included, in Appendix B, comments on the conforming amendments included in the Proposal.

#### Critical audit matters

We agree, as noted in the Proposal, that including critical audit matters (CAMs) in the auditor's report "...could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging." We also agree that the CAMs should be "...presented in language and in a format that is clear, concise, and understandable to a financial statement user." We support these objectives and believe these enhancements to the report could be beneficial to users of financial statements.

However, we do have some significant operational concerns which are highlighted below, along with suggestions for improvement.

#### **Determining CAMs**

Paragraph 8 of the Proposal would require, when identifying a CAM, auditors to consider matters included in the engagement completion document, matters reviewed by the engagement quality reviewer and matters communicated to the audit committee. We are concerned that this very general approach will be too broad and could lead to practices that are inconsistent with the Board's objectives.

We note that auditors presently identify a wide range of matters in the engagement completion document, in discussions with the engagement quality reviewer and in communications with the audit committee. Without revisions to the proposal that could assist auditors with how to further filter these matters, auditors will find it difficult to select, from this universe of issues, those matters that are most important to the audit. In this regard, we are concerned that certain matters that an auditor appropriately determined not to be CAMs at the time the audit report was issued, may, with the benefit of hindsight, be unfairly subject to second guessing. This risk, combined with the requirement in paragraph 14 of the Proposal to document matters addressed in the audit that "would appear to meet the definition" of a CAM, but were not so reported, could prompt auditors to identify a large number of matters in the audit report, some of which might not meet the Board's expectation of a CAM. This would reduce the relevance of the CAMs, which would be contrary to the Board's stated objectives.



# Communicating CAMs

Paragraph 11 of the Proposal would require the auditor to describe the considerations that led the auditor to determine that a particular matter is a CAM. However, we note that the example CAMs in the Proposal appear to indicate that the description of *each* CAM should address *each* of the paragraph 9 considerations that were present. If this is the PCAOB's intent, we believe it raises the following concerns:

- ► Checklist approach to the communication of CAMs Requiring a description of all of the factors that may be present could result in a "checklist" approach to CAM communication. This could result in a long list of all of the items that might have related, even tangentially, to the matter. Many of these matters would be of limited use to financial statement users and may obscure the most significant factors the auditor considered when determining the matter was a CAM. For example, paragraph 9 lists consultations outside the engagement team as a consideration. We believe that auditors typically consult with a firm's national office or engage firm specialists in response to a challenging audit issue, not as part of a determination that the matter is critical. Moreover, the decision to consult with others outside the engagement team may depend more on the expertise or prior experiences of the engagement team. Requiring a description of these consultations in the audit report may lead to inappropriate inferences about the quality of other audits in which similar issues arose but consultations were not performed. As such, as more fully described below, we believe requiring the *principal consideration* that led the auditor to determine a matter is a CAM communication would be a more effective way of accomplishing the Board's objective.
- ▶ Potential inclusion in the auditor's report of original information The examples in the Proposal would appear to require the communication of certain specific matters, such as control deficiencies less severe than a material weakness and corrected and accumulated uncorrected misstatements related to the CAM. At present, public companies are not required to disclose these matters, and we are concerned that having the auditor serve as the source of this and other original information about the entity could blur the roles of management and the auditor. We believe a final standard should stress that the auditor should avoid conveying, through a CAM, information that the entity is not required to disclose.
- Materiality Certain matters addressed in the audit may present challenges, but may not relate to items disclosed in the financial statements. For example, an audit team may expend effort evaluating a company's accounting for a potential loss contingency and ultimately concur with the company's conclusion that no accrual or financial statement disclosure is necessary. The Proposal is unclear about whether a CAM communication would be required in this case. We do not believe it would be appropriate for the auditor to describe matters in the auditor's report if they do not relate to material matters disclosed in the financial statements.
- Potential for user misunderstanding While we recognize that the Proposal would not require the auditor to describe specific audit procedures in the CAM communication, the examples in the Proposal suggest that such a discussion should be so included. We note that it is difficult to

See on page A5-36 of the proposal, the Board states that "...when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so."



explain, in a few sentences, the significant audit effort that may have gone into a particular area. We are also concerned that users of the financial statements might misunderstand the communication of audit procedures and may think it means the auditor has provided a specific level of assurance on the CAM (i.e., a piecemeal opinion). Further, if audit procedures are described in the audit report, we believe that preparers may also request that the results of such procedures be included in the description of the CAM to address users' questions or concerns about the outcome of the procedures. This would further exacerbate the potential for users to interpret the description of a CAM as providing a specific level of assurance on a particular matter.

# **Documenting CAMs**

As noted above, paragraph 14 of the Proposal would require the auditor to document why "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters." We do not believe that such a requirement is operational because it is unclear how an auditor could easily demonstrate that such a matter *is not* a CAM. Consistent with the concern raised above, we fear that this requirement, if adopted, could result in auditors communicating a large volume of matters in order to avoid later challenges as to the completeness of the CAMs reported. Such an outcome would be contrary to the intent of the Proposal, and would likely add significant costs to the audit process without a corresponding benefit. In addition, inclusion of a significant number of matters in the audit report will likely result in significant time involved in developing their descriptions, which could put additional pressure on issuer's filing deadlines. As a result, we believe this aspect of the Proposal must be clarified.

# Suggestions to improve the PCAOB's CAM framework

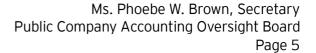
Given the challenges noted above, we believe the changes we suggest below will result in:

- The identification of the matters in the audit of the financial statements that were most important
- A description of matters that should provide useful information to financial statement users, while minimizing potential unintended consequences
- A more efficient and effective process for identifying, describing and documenting the auditor's basis for his or her determination of CAMs

#### **Determining CAMs**

As a starting point, we believe that the auditor should initially identify matters that were significant to the audit of the financial statements (significant audit matters). We believe all such matters should already be reflected in the required communications to the audit committee under PCAOB Auditing Standard (AS) No. 16. Such a CAM determination starting point is consistent with the Board's rationale for identifying the types of significant matters to be communicated to the audit committee.<sup>2</sup>

We note, for example, in the adopting release for AS 16, the Board noted (emphasis added): "Auditing Standard No. 16 is intended to improve the audit by fostering constructive dialogue between the auditor and the audit committee about significant audit and financial statement matters. The standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process."





This approach would also have the benefit of more closely aligning the identification of CAMs with the IAASB's proposal.

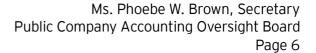
From this initial population of significant audit matters, we believe the consideration of the factors included in paragraph 9 of the Proposal would help the auditor, using his or her judgment, to identify those matters most important to the audit of the financial statements. In our view, the determination of CAMs should represent those significant audit matters that (1) were material to the financial statements, (2) involved the most challenging, subjective or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence or posed the greatest challenge to the auditor in forming an opinion on the financial statements <u>and</u> (3) resulted in the most significant interaction with the audit committee. We note that this approach builds upon the PCAOB's criteria in the following manner:

- Focuses on matters that are material to the financial statements The PCAOB's release notes that CAMs "could help investors and other financial statement <u>users focus on aspects of the company's financial statements that the auditor also found to be challenging.... that could enable them to analyze more closely any related financial statement accounts and disclosures." (emphasis added) We believe this is the key benefit to users of the financial statements. As such, we believe the auditor's determination of CAMs should include consideration of only matters that are material<sup>3</sup> to a company's financial statements.</u>
- Facilitates identification of most challenging matters Consistent with the Proposal, we believe the factors included in paragraph 9, when considered in conjunction with our suggestions, help facilitate the identification of the most important matters.
- ▶ Resulted in the most significant interaction with the audit committee Consideration of matters that resulted in the most significant interaction with the audit committee builds upon investor requests for further insights into auditor/audit committee communications and is consistent with the audit committee's role of representing the interests of shareholders. In addition, we believe that, in practice, auditors and audit committees tend to spend the most time focusing on matters that have the characteristics, as generally contemplated in the Proposal, of CAMs. Accordingly, we believe the ultimate standard should reflect what we see in practice, and the extent of the auditor's interaction with the audit committee on the various matters that arise during the execution of an audit is an important measure in CAM determination. We believe changes along these lines, particularly the need for the additional filter tied to the extent of audit committee interaction on a significant audit matter, will improve the operational and cost effectiveness of the requirements.

#### Communicating CAMs

As previously discussed, we do not believe that the description of a CAM needs to include all of the factors that may relate to the matter. In fact, we believe such an approach would lead to problems in practice and would likely confuse users of the audit report. Rather, we recommend that the Board revise the Proposal such that auditors should focus on the *principal* consideration (or, in some more

Although the concept of materiality is not mentioned in connection with the determination of critical audit matters in the Proposal, we note that such a concept is listed in one of the examples regarding the auditor's determination of critical audit matters. See Proposal page A5-76.





limited situations, the principal considerations) that led the auditor to determine that a matter was a CAM. We believe that in many cases, the principal consideration that led the auditor to determine that a matter was a CAM will also be apparent from a company's descriptions of such matters in the audited financial statements. Examples would include a high degree of complexity or subjectivity in determining the related amount or disclosure. We believe users of an audit report would benefit from the identification of the CAM and a short description of why the auditor concluded it was a CAM. The description should be concise and fact based, and we believe the example CAM communications in the CAQ letter illustrate this point. We also see significant challenges in practice, and the potential for user confusion, if the Board goes much beyond this approach, since a lengthy description of all of the factors may obscure the most significant issue the auditor considered when determining whether the matter was a CAM.

As noted above, we are especially concerned that a user might infer that a separate level of assurance is being provided on the matter described in a CAM, particularly if the description were to include a discussion of audit procedures performed. However, we also recognize that there may be some circumstances when a description of the CAM's effect on the audit may be necessary to explain why the matter was a CAM.<sup>4</sup> In our view, this may be the case when the principal consideration that led to the determination that a matter was a CAM was not apparent from the disclosures in the audited financial statements. For example, consider a situation in which a matter is identified as a CAM due to a material weakness in a company's internal control over financial reporting (ICFR) in an area that was integral to the determination of a material account or disclosure. While the company may describe the internal control matter in the filing that includes the audited financial statements, the audited financial statement may not, and a description of how the auditor considered the matter in the performance of the audit may be necessary to appropriately communicate to financial statement readers why the matter was a CAM. As a result, we recommend the Board revise the Proposal by stating explicitly that the auditor could provide a description of the CAM's effect on the audit if, and only if, the auditor considers it necessary to describe why a matter was determined to be a CAM. In this regard, while we observe that the examples in the CAQ letter include, in bracketed text, illustrations of potential descriptions of a CAM's effect on the audit, we believe this language is unnecessary given the facts and circumstances in those examples.

We have also included, in Appendix A, two examples of situations in which we believe an auditor may find it necessary to describe the effect that a CAM had on an audit.

#### **Documenting CAMs**

We believe it is important that the audit workpapers support the auditor's rationale for the determination of CAMs. As noted above, however, we do not believe the proposed documentation guidance is operational. Instead, we believe the PCAOB standard would be more practical if the auditor was required to document 1) those matters that were communicated to the audit committee that were determined to be significant audit matters and (2) which significant audit matters the auditor determined to be CAMs. Key to this determination is the auditor's assessment of the factors described in paragraph 9 of the Proposal and the consideration of those matters that involved the

We note, however, that each of the PCAOB's examples appears to include such descriptions (see pages A5-65 through A5-78).



highest degree of interaction with the audit committee. We believe this is how practice is working presently where, in view of all of the issues required to be communicated, audit committees typically ask for the auditor to highlight those most critical to the audit. These are the matters that tend to receive the most attention and interaction.

#### The importance of robust field testing

Due to the Proposal's significance, we strongly believe that robust field testing should be conducted to help identify unintended consequences, ambiguities or the potential for inconsistencies in application. We believe a careful consideration of the results of field tests would improve the quality of any final standard. Field testing would also provide information about the likely additional audit effort required and the related cost. While we believe the PCAOB would benefit from conducting such an effort itself, we are currently field testing the Proposal on a number of engagements and intend to share our observations with the PCAOB in early 2014.

#### Other information

We support the auditor's performance responsibilities related to other information being better codified in the standards. We also support describing, in the audit report, the auditor's responsibilities for other information. We believe this would respond to requests from financial statement users to obtain a better understanding of the auditor's responsibilities in this area.

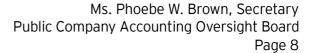
However, we do not support the Proposal's contemplated changes to current requirements and practices in the following three areas: (1) expanding the auditor performance requirements related to other information to "read and evaluate" from "read and consider," (2) the lack of certainty surrounding the scope of the "other information" covered by the Proposal and (3) requiring the auditor's affirmative statement about other information to be reflected in the audit report.

We believe these issues, if not addressed, will expand the auditor's other information performance responsibilities significantly beyond what the PCAOB believes is today's current practice, and the contemplated reporting requirements will result in increased liability risks for audit firms. Such outcomes will result in higher audit performance and reporting costs.

# Expanding auditor performance requirements to "evaluate" other information

#### Use of the term "evaluate"

PCAOB interim standard AU 550, Other Information in Documents Containing Audited Financial Statements, (AU 550) requires the auditor to "read and consider" whether the other information, or the manner of its presentation, is materially inconsistent with information in the financial statements or the manner of its presentation.<sup>5</sup> If while reading the other information for a material inconsistency, the auditor becomes aware of information that the auditor believes is a material misstatement of fact, the auditor is required to discuss the matter with management and, if the matter is not resolved,





consider other actions.<sup>6</sup> The Proposed Other Information Standard would require the auditor to "evaluate" the other information for a material inconsistency or a material misstatement of fact based on procedures performed, including reading the other information.

We understand that the PCAOB replaced "consider" with "evaluate" because AU 550 does not specify procedures to be performed by the auditor on other information. As more fully articulated in the CAQ's legal analysis, we believe the proposed use of the word "evaluate" implies a significantly higher expectation of performance on other information than what is required under the existing standard. For instance, we believe use of this term might result in an expanded responsibility for not only what the issuer has disclosed within its other information, but also for whether the issuer has identified all matters required to be disclosed (i.e., to assess completeness of all Regulation S-K requirements ). In other words, the auditor might be required to examine not only what the issuer has disclosed, but what it has not disclosed. Based on staff commentary on the Proposal provided at the 13 August 2013 open meeting, it is our understanding that the Board did not intend to significantly increase the performance standards in this area, so this issue needs to be clarified. In addition, as more fully described below, we believe the use of the term "evaluate" to describe the auditor's "conclusion" in the auditor's report could cause users to perceive that the auditor is providing a form of reasonable assurance on such information.

# Consideration of "relevant audit evidence obtained and conclusions reached during the audit"

The Proposed Other Information Standard would require the auditor to base the evaluation on "relevant audit evidence obtained and conclusions reached during the audit." We recognize that the auditor must use knowledge gained from the audit when considering whether a material inconsistency, or material misstatement of fact, exists in the other information. However, we are concerned that, as currently drafted, the requirement could be interpreted to mean that an auditor may need to perform a search for any and all documentation included in the audit workpapers related to each qualitative and quantitative statement in the other information. We believe that such an expectation would represent a significant expansion of auditor obligations relative to current practice.

#### Other information not directly related to the financial statements

The Proposed Other Information Standard would require the auditor to perform procedures on other information that are not directly related to the audited financial statements. In many instances, we believe the auditor may not have a basis (from the audit or otherwise) to "evaluate" such information based on information gained during the audit. However, from the proposed descriptions (and conclusion) included in the audit report, it would not be clear to users of the financial statements that the auditor may not have had a basis to "evaluate" such information. Such an outcome would appear to be contrary to the PCAOB's objectives of clarifying for users the auditor's responsibilities in this area.

<sup>&</sup>lt;sup>6</sup> AU 550.05

Paragraph 4 of the proposed other information standard



# Scope of "other information"

The Proposed Other Information Standard defines other information broadly as information in the annual report, other than the audited financial statements and the related auditor's report, and includes documents contained in the list of exhibits to<sup>8</sup> and information incorporated by reference in the annual report. We believe auditors would benefit from the following clarifications:

- ▶ Identification of the exhibits that fall within the scope of the auditor's performance responsibilities For instance, certain exhibits (e.g., acquisition plans, material contracts) may have been subject to audit procedures due to their relevance to the audit of the financial statements. It may not be appropriate to subject these exhibits to the performance procedures within the Proposed Other Information Standard, since we may have more than read and evaluated this information.
- Performance obligations related to the proxy statement The Proposed Other Information Standard would require the auditor to evaluate other information included in the proxy statement. Because the proxy statement may not be filed until 120 days after year-end, which may be after the Form 10-K is filed, it is unclear how this requirement can be applied in practice. In addition, if such procedures are performed on the proxy statement after the auditor's report is filed, it is unclear whether the auditor would be required to reissue an audit report that is dual-dated.

#### Requiring the auditor's conclusion about other information in the report

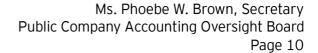
While we support describing, in the audit report, the auditor's responsibilities for other information, we do not support the proposed requirement for the auditor to assert, based on relevant audit evidence obtained and conclusions reached during the audit, whether the other information contains a material inconsistency, a material misstatement of fact, or both. We believe that providing this "conclusion" may be interpreted by investors and other financial statement users as providing an opinion on other information, even though the proposed other information standard requires a statement that the auditor did not audit the other information. To address this concern, we believe the Board should revise the Proposal to require a description of the auditor's responsibilities with respect to other information, including responsibilities related to material inconsistencies or misstatements of fact that are not addressed by the company. In addition, as more fully discussed in the CAQ letter, we believe that the requirement to make an affirmative statement with respect to the results of the procedures performed on the other information would result in significant increased liability risk to audit firms. Accordingly, we recommend that this statement be removed as a requirement.

# Suggestions on the Proposed Other Information Standard

We support the suggestions provided by the CAQ, which we believe would clarify the auditor's performance and reporting responsibilities related to other information, help address some of the increased liability risks resulting from the proposed changes and still enable the PCAOB to achieve its objectives in this area. We have summarized key elements of these suggestions below.

<sup>8</sup> See the proposed other information standard, footnote 15, appendix 6.

<sup>&</sup>lt;sup>9</sup> See the proposed other information standard, "Note" to paragraph 11.





#### Replacing "evaluate" with "perform certain limited procedures"

As indicated by the PCAOB, "evaluate" consists of reading the other information and performing specific procedures. <sup>10</sup> We do not support the use of this word to describe the results of the procedures required by the Proposal. As such, we believe the PCAOB should consider replacing "evaluate" with "perform certain limited procedures" in the audit report. As more fully discussed below, we also believe that the standard should articulate, in general terms, the limited procedures to be performed (on information that is directly related to the audited financial statements versus that not directly related to the audited financial statements), and that the auditor's report should also include a general description of these procedures.

#### Performance requirements

We believe the Board should revise the requirements to make a clearer distinction between the performance requirements related to information that is directly related to the audited financial statements and information that is not directly related to the financial statements.

We believe limited procedures (beyond reading) should apply only to "other information directly related to the audited financial statements," which would include information derived from either (1) the audited financial statements or (2) accounting records subject to the audit. This change would also make clear that the auditor does not have to perform an extensive search of the audit workpapers to determine whether other information was addressed in the audit. With respect to other information not directly related to the audited financial statements, we believe the Board should revise the requirements such that the auditor's performance responsibilities are to read the information and follow up accordingly if, based on knowledge gained during the course of the audit, any potential material misstatements of fact are identified.

In addition, we believe that it is important that the auditor consider the significance of the other information when performing the required procedures. We don't believe it is the Board's intention, nor would it be beneficial from a cost-benefit perspective, to have performance standards apply to other information that is not material. Accordingly, we recommend that the Board revise the requirement so that the auditor would only be required to perform procedures beyond reading with respect to material other information directly related to the audited financial statements.

We believe that these suggestions, combined with others in the CAQ's letter, would more closely align the Proposal's guidance on other information with what are often viewed as best practices under current standards.

#### Communicating matters related to other information in the auditor's report

We support additional transparency regarding the auditor's responsibilities related to other information in the audit report. Specifically, we believe the report should:

Describe the auditor's responsibilities to perform certain limited procedures on other information

Paragraphs 3-4 of the proposed other information standard



- Describe the limited procedures performed
- Emphasize that these limited procedures do not constitute an audit or review of the other information
- Include a statement that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement, or both, in the audit report
- Include a description of the material inconsistency, the material misstatement of fact, or both in situations where the auditor has become aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised

We believe that this reporting would clearly communicate the auditor's responsibilities regarding other information and, if and when applicable, identify an unresolved material inconsistency with the financial statements or a material misstatement of fact of which the auditor is aware. It would also help mitigate the risk that investors or other financial statement users would infer that the auditor has a greater responsibility for the other information than is required by the Proposed Other Information Standard. Finally, we believe this reporting would help address, at least to some extent, the significant liability concerns as described in the CAQ letter.

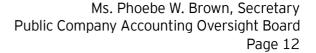
#### Clarifying other information documentation requirements

We noted that the Proposal does not provide guidance on the nature and extent of documentation that would be required with respect to fulfilling the auditor's other information responsibilities. The proposal to "evaluate" other information implies that auditors would have to document the source of information for every qualitative and quantitative statement in the other information, regardless of whether the other information is directly related to the audited financial statements. Such an effort would be significant and, in our view, would not have a commensurate benefit to audit quality. While we believe the recommendations above will assist in focusing the auditor's documentation efforts, by more clearly articulating the auditor's performance requirements that go beyond reading the other information, we recommend that the PCAOB provide guidance on how the auditor should document the procedures performed.

# **Auditor tenure**

The Board has stated that to date, it has not found a link between audit quality and auditor tenure. As a result, we are concerned that requiring tenure information in the auditor's report, particularly at the end of the auditor's description of his/her independence responsibilities, would imply, incorrectly and without an evidentiary basis, the PCAOB has determined such a correlation exists. As such, we do not support the inclusion of auditor tenure information in the audit report.

We do support the consideration of other ways of making auditor tenure more transparent. We note that disclosure about the length of the auditor relationship is becoming more common in practice. For





example, a recent EY survey found that a growing number of audit committees of Fortune 100 companies are disclosing the tenure of their auditors in the audit committee reports included in annual proxy statements. <sup>11</sup> In addition, we note that the CAQ, in collaboration with several governance organizations, recently encouraged all audit committees to consider making such disclosures in a recent publication, "Call to Action." <sup>12</sup>

While the Board could consider having auditors provide tenure information in the PCAOB's annual report on Form 2, we believe that tenure information may be most meaningful if provided by audit committees in the context of their evaluation of the auditor. As such, we believe the PCAOB should work with the SEC to explore the best possible means of providing auditor tenure information to users of public company financial statements.

#### Other considerations

#### Liability concerns

As more fully discussed in the CAQ's letter, we believe the proposed identification and disclosure of CAMs, as well as the proposals related to other information, pose risks of increased legal liability that are real and substantial. We strongly believe the PCAOB must weigh the potential benefits of the Proposal against the increase in auditor liability and costs that we believe would occur. While we believe that the improvements we suggest in this letter would help to mitigate (at least, to some extent) the additional liability exposure, such risks would, even then, remain a significant issue for the profession and one that requires much more thought and analysis than is currently evident.

Scope – broker dealer, investment companies, employee benefit plans and emerging growth companies

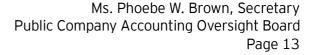
#### Critical audit matters

We do not believe that auditors of the financial statements of brokers and dealers, investments companies and employee benefit plans (i.e., employee stock purchase, savings and similar plans) should be subject to the identification, communication and documentation of CAMs under the Proposal.

Generally, benefit plans and registered investment companies are designed for a specified purpose and these entities tend to be heavily invested in financial assets. As a result, we suspect the CAMs for these entities would be very similar (i.e., matters related to valuing financial assets). These entities already follow extensive financial statement disclosure requirements for financial assets, and we believe users of these reports tend to understand that fair value issues are important to both the preparation and audit of these financial statements. Consequently, we question whether extending the requirements to describe CAMs to audit reports of investment companies and employee benefit plans would provide a significant benefit to users of financial statements of these entities.

<sup>&</sup>lt;sup>11</sup> Audit Committee Reporting to Shareholders, 2013 Proxy Season, EY (link).

Enhancing the Audit Committee Report: A Call to Action, issued by the Audit Committee Collaboration consisting of the following organizations: National Association of Corporate Directors, New York Stock Exchange, Corporate Board Member, Tapestry Networks, Association of Audit Committee Members, Inc., and the CAQ (link).





As noted in the PCAOB Release, brokers and dealers are primarily closely held (the PCAOB's Office of Research and Analysis says approximately 75% of brokers and dealers have five or fewer direct owners), and the direct owners are generally part of the entity's management. In addition, many brokers and dealers are part of an issuer parent entity so the CAMs related to brokers and dealers would be considered in the parent's CAM communications. Accordingly, we believe that requiring the auditors of these entities to communicate CAMs would not provide financial statements users with additional relevant information to justify the additional cost.

#### Other information

In our view, audits of brokers and dealers and employee benefit plans should be excluded from the scope of the Proposed Other Information Standard. We believe that the compliance or exemption report required to be filed by brokers and dealers under Exchange Act Rule 17a-5<sup>13</sup> and required to be reported on by auditors under the *Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission* <sup>14</sup> provides users of their financial statements with sufficient information to make any additional reporting by the auditor for such entities under the Proposed Other Information Standard unnecessary. Moreover, Form 11-Ks filed by employee benefit plans contain a limited amount of other information.

# Emerging growth companies

We do not think that emerging growth companies (EGCs) should be excluded from the auditor reporting and other information standards. We believe EGCs exhibit characteristics similar to other public companies and that users of financial statement will benefit from similar auditor reporting requirements. In addition, we believe that the recommendations provided above should help mitigate the costs (for audits of EGCs and all other public companies) of the expanded auditor performance and reporting requirements reflected in the Proposal.

\* \* \* \* \*

We would be pleased to discuss our comments with the Board or the PCAOB staff at your convenience

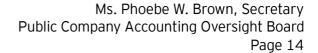
Yours sincerely,

Ernst + Young LLP

Appendix A – Example CAMs reflecting the "effect on the audit" description in the audit report Appendix B – Comments on the conforming amendments

SEC Release No. 34-70073, Final Rule, Broker-Dealer Reports (link).

<sup>&</sup>lt;sup>14</sup> PCAOB Release 2013-007 (link).





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#### **PCAOB**

James R. Doty, Chair Lewis H. Ferguson, Board Member Jeanette M. Franzel, Board Member Jay D. Hanson, Board Member Steven B. Harris, Board Member Martin F. Baumann, Chief Auditor

# **Securities and Exchange Commission**

Mary Jo White, SEC Chairman Luis A. Aguilar, SEC Commissioner Daniel M. Gallagher, SEC Commissioner Kara M. Stein, SEC Commissioner Michael S. Piwowar, SEC Commissioner Paul A. Beswick, SEC Chief Accountant Brian T. Croteau, SEC Deputy Chief Accountant

# Appendix A – Example CAM disclosures reflecting the "effect on the audit"

We have included the following two examples to demonstrate situations in which we believe an auditor may find it necessary to describe, in the audit report, the effect a CAM had on an audit.

# Example 1 – Implementation of new inventory system

#### Background

XYZ Company (the "Company") designs, manufactures, sells and services customized widgets. Revenues are recognized in accordance with the percentage-of-completion contract accounting method. During 2013, XYZ Company implemented a new inventory system, as its previous system was no longer supported by the vendor and was not suited to the Company's anticipated growth plans. The new system was also intended to better facilitate the gathering of production information and allow it to more efficiently plan, manage and track the production process. The system will include the following functionality, among others:

- Develop material requirements
- House bills of materials
- Collect production floor data
- Manage suppliers (ordering and receiving of materials)
- Manage the Company's inventory
- Track field service and warranties
- Track sales of parts and accessories

The new system caused the Company to redesign its internal controls in the inventory and revenue recognition areas. The Company worked with its software vendors to run the new and old systems on a parallel basis over a six-month period. As part of this process, it implemented controls to reconcile any differences in the cost information output from the two systems, as well as any differences in contract amounts. After the end of the 3<sup>rd</sup> quarter, the Company determined that the new system was operating effectively and ceased the parallel operations effective October 1, 2013.

# Company Disclosures

#### Significant Accounting Policies – Notes X and Y

XYZ Company (the "Company") designs, manufactures, sells and services customized widgets. Revenues are recognized in accordance with contract accounting. The Company recognizes contract revenues under the percentage-of-completion method which is based on contract costs incurred to date compared with total estimated contract costs. Changes in estimates of total contract revenue (e.g., customer amendments to the agreed-upon design), total contract cost or the extent of progress

towards completion are recognized in the period in which the changes in estimates are identified. Estimated losses on contracts are recognized in the period in which the loss is identified. If the final outcome of a contract cannot be reasonably estimated, but a loss on the contract is not expected, the Company recognizes revenues under the percentage-of-completion method based on a zero profit margin until more precise estimates can be made. If and when the Company can make more precise estimates, revenues and costs of revenues are adjusted in the same period.

Contracts accounted for in accordance with contract accounting are billable upon achievement of milestones specified in the contracts or upon customer acceptance. Costs incurred and revenues recognized under the percentage-of-completion method in excess of customer billings are included in "Accounts receivable" in the Consolidated Balance Sheets. Customer billings in excess of costs incurred and revenue recognized under the percentage-of-completion method, which typically reflect initial down payments, are included in "Advance payments from customers" in the Consolidated Balance Sheets.

<u>Item 9A. Controls and Procedures: Changes in Internal Control Over Financial Reporting</u>

During the 4<sup>th</sup> quarter, we implemented a new inventory system, which caused us to revise internal controls in the inventory and revenue areas.

The Company worked with its software vendors to run the new and old systems on a parallel basis over a six-month period. As part of this process, we also implemented controls to reconcile any differences in the cost information output from the two systems, as well as any differences in contract amounts. After the end of the 3<sup>rd</sup> quarter, the Company determined that the system was operating effectively and ceased the parallel operations effective October 1, 2013.

#### Auditor's Considerations

#### **CAM Considerations**

The external auditor determined this matter represented a CAM due to the following:

- Inventory, revenues and cost of goods sold are material financial statement accounts. The transition to the new system represented a significant area of risk to the accumulation of costs related to the Company's production of widgets, as well as the determination of revenue. The auditor made changes to the audit approach and planned procedures in this area in response to the changes in the Company's systems and underlying processes.
- Significant audit effort was expended evaluating the adequacy of the new controls related to the input of production cost and tracking information into the new system, including the reconciliation controls utilized during the 6-month period where both systems were operated in parallel.
- Significant effort was expended by the audit team, including significant involvement of the firm's IT personnel, to evaluate the effectiveness of the Company's IT controls related to the new system, including logical access, security and other application controls related to the accumulation of cost information related to production, inventory tracking/costing, supplier management, and revenue generation.

The Company's audit committee was involved in tracking the progress the Company made in this area. For example, the audit committee (1) requested that management provide regular status updates related to the new system development and the related conversion, (2) inquired of management, internal audit and the external auditor about any challenges identified during the conversion, (3) requested the external auditor to specifically discuss the manner in which the audit approach would address the risks associated with the conversion and (4) directed the internal audit department to devote significant resources to evaluating the adequacy of the Company's controls in this area. As a result, this interaction represented some of the most significant with the audit committee during the course of the audit.

#### Example CAM Disclosure

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide assurance on individual accounts or disclosures. The communication below is not intended to identify all matters we considered to be significant to our audit. Other matters that we determined were not critical audit matters were discussed with the audit committee during the course of our audit.

# Implementation of New Inventory System

The Company recognizes contract revenues under the percentage-of-completion method, which are based on contract costs incurred to date compared with total estimated contract costs. The amount of revenue recognized requires the company to estimate total contract costs at the outset of a contract and revise those estimates over the life of the contract as circumstances dictate.

During the 4<sup>th</sup> quarter, the Company implemented a new inventory accounting system. The system is integral to the accumulation of contract cost information which, in turn, is the key driver in the Company's determination of revenue to be recognized. Given the significance of the inventory system to the Company's ability to track and record production expenses, and in turn recognize revenue, we determined that the Company's implementation of the new inventory system was a critical audit matter in the audit of the financial statements as of and for the year ended December 31, 2013.

Our audit involved testing the company's conversion from its previous system to the new system, including evaluating the adequacy of the reconciliation controls used during a 6-month period where both systems were operated in parallel. Our audit procedures also included an evaluation of the revised internal control policies and procedures related to the new system. The Company's inventory and revenue recognition policies are discussed in Notes X and Y to the financial statements.

#### Example 2 – Material Weakness in Internal Control Over Financial Reporting Identified During the Audit

# Background

XYZ Company (the "Company") is a leading manufacturer of widgets and is a non-accelerated filer with a non-integrated audit. During the preparation of the 2013 year-end financial statements, an error was identified in the current-year calculation of the valuation allowance recorded for deferred tax assets. The Company determined that the error was the result of a control deficiency regarding the preparation and review of the calculation of the valuation allowance by senior tax personnel. The review did not appropriately consider the reasonableness of the assumptions used in projecting taxable income and reversals of existing taxable temporary differences when developing the valuation allowance. Given the material amount of deferred tax assets recognized by the Company and the nature and extent of the control deficiency identified, the Company determined that a material weakness in its internal control over financial reporting existed as of December 31, 2013.

#### Company Disclosures

#### Item 8 – Financial Statements and Supplementary Data in 10-K

Summary of Significant Accounting Policies – Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences or temporary differences between the financial statement carrying amounts and the tax bases of the assets and liabilities. Deferred tax balances are adjusted to reflect tax rates, based on current tax laws, which will be in effect in the years in which temporary differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance when management determines that it is more likely than not that some portion or all of the deferred tax assets will not be realized (see Note Y)....

#### Item 9A-Controls and Procedures in 10-K

Evaluation of Disclosure Controls and Procedures

...Based on our evaluation, our CEO and CFO concluded that as of December 31, 2013, our disclosure controls and procedures are ineffective related to the preparation and review of the valuation allowance recorded for certain deferred tax assets...

# Management's Report on Internal Control Over Financial Reporting

We assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013 using the criteria set forth by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in *Internal Control – Integrated Framework....* Based on our assessment, we have concluded that we did not maintain effective internal control over financial reporting as of December 31, 2013, due to the material weakness in our internal control over financial reporting described below.

We did not maintain effective controls over the preparation and review of the valuation allowance recorded for certain deferred tax assets. Specifically, the review of the valuation allowance did not consider all relevant facts and circumstances. This resulted in an adjustment during the 4<sup>th</sup> quarter to the Company's financial statements as of and for the year ended December 31, 2013. While the adjustment was not material to the prior year, management has concluded that this control deficiency, if not effectively remediated, could result in misstatements of the income tax accounts identified in Note X

of the consolidated financial statements that would result in a material misstatement of the Company's annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, we have determined that this control deficiency constitutes a material weakness.

In response to the identification of the material weakness, in early 2014, management plans to take actions to remediate its internal controls over the preparation and review of the calculation of valuation allowances recorded for deferred tax assets. The Company plans to implement more robust reviews over the determination of valuation allowances recognized, including more formal comparisons between deferred tax assets and all sources of future taxable income. In addition, the Company has added resources that will enable management review and oversight for those valuation allowances that involve a higher degree of inherent complexity and judgment required on the part of management.

#### Auditor's Considerations

#### **CAM Considerations**

The external auditor determined this matter represented a CAM due to the following:

- Deferred tax assets are material to the Company's financial statements.
- The estimate was complex and highly subjective, requiring projections of future taxable income and reversals of taxable temporary differences.
- The control deficiency identified was determined to be a material weakness by management and the external auditor, which resulted in changes to the auditor's risk assessments and the performance of additional control and substantive procedures in this area.
- An adjustment was identified as a result of the control deficiency related to the deferred tax valuation allowance.
- Due to the sensitivity of the area, the valuation allowance was typically the source of significant interaction with the audit committee. In addition, upon the identification of the error and related control deficiency, further interaction occurred related to the misstatement, the related control deficiency and management's remediation plans. This interaction represented some of the most significant with the audit committee during the course of the audit.

#### Example CAM Disclosure

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide assurance on individual accounts or disclosures. The

communication below is not intended to identify all matters we considered to be significant to our audit. Other matters that we determined were not critical audit matters were discussed with the audit committee during the course of our audit.

#### Material Weakness Related to Deferred Tax Valuation Allowance

The Company determined that a material weakness in internal control over financial reporting existed as of December 31, 2013. Specifically, the Company determined it did not maintain effective controls over the preparation and review of the valuation allowance recorded for certain deferred tax assets. The determination of the valuation allowance is subject to significant estimation, including projections of future taxable income and reversals of taxable temporary differences.

Given the significance of the deferred tax assets recognized in the financial statements and the identification of the material weakness related to the determination of such amounts, we determined that our evaluation of the Company's valuation allowance for deferred tax assets represented a critical audit matter in the audit of the financial statements as of and for the year-ended December 31, 2013.

Our audit procedures included evaluating the reasonableness of the assumptions used in the projections of future taxable income and reversals of taxable temporary differences, as well as evaluating the controls over the preparation and review of the deferred tax asset valuation allowance. The Company's policy for accounting for income taxes and related income tax disclosures are discussed in Notes X and Y to the financial statements.

# Appendix B – Comments on the conforming amendments

Comment Number	Reference	Observation
1	Para. 1	The auditor's report when the auditor expresses an unqualified opinion on the financial statements is defined as the "auditor's unqualified report." This term is used throughout the proposed standard. We believe that the terms "unqualified," "qualified," "adverse," and "disclaimer" should be reserved for describing the auditor's opinion, rather than the auditor's report.  On a related matter, the Amendments to PCAOB AU 508.10 refer to a departure from the "auditor's unqualified report," but the new title of this amended standard is "Departures from Unqualified Opinions"
2	Para. 5	We suggest that "The Auditor's Unqualified Report" requirements section should be presented after the "Basic Elements" section.
3	Para. 5.b.	The proposed OI standard indicates that the auditor's unqualified report includes communication of Critical Audit Matters as described in paragraphs 7-14. Paragraph 5 could be eliminated if the explanatory language/provision discussion were included in the Basic Elements section and if the Critical Audit Matters discussion were moved to paragraphs 7-14. Note that the Amendments to PCAOB AU 508.20A refer to paragraphs 7-13 rather than to paragraph 5.
4	Para. 5.c.	We suggest that "Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs 15-16" should be included in the Basic Elements section.
5	Para. 5.c.	Under the proposed auditor reporting standard, the auditor's report could have a matter discussed in both the Critical Audit Matters section of the report and in an explanatory paragraph. We suggest that the PCAOB consider addressing this situation in the new standard. One alternative would be that matters would not be required to be repeated in the explanatory paragraph if the same information is already addressed in the Critical Audit Matters section.
7	Auditor Reporting Standard Page A1-15	The Introduction section includes the phrase "statements of operations." We suggest that this be updated for issuance of ASUs 2011-05 and 2011-12 for comprehensive income. For example, this could state "the statement of comprehensive income" or "the statement of comprehensive income and the statement of income."

	1	
8	Auditor Reporting Standard  Appendix B Page A1-15  Appendix 3 Page A3-5	We suggest that the defined term (PCAOB) be presented after (United States) rather than before that term since after this definition, only PCAOB is used. PCAOB should define the entire name of the PCAOB. Same comment for the Amendments to AU 722.38. Note that the amendments to AU 722.39 already have (PCAOB) after (United States).
9	Auditor Reporting Standard Appendix B Page A1-15	We suggest that the phrase "appropriate evidence" be revised to say "appropriate audit evidence."
10	Auditor Reporting Standard Appendix 3 Page A3-5	The updates to the report on internal control over financial reporting include the auditor tenure language. We challenge whether the auditor tenure language is needed in the ICFR report when separate reports are issued if it has already been included in the report on the financial statements. If it is retained, we suggest that guidance be provided on whether the tenure that is disclosed should be the same as that disclosed in the report on the financial statements, or whether this tenure disclosure would relate to the number of years that the auditor has been engaged to audit ICFR.
12	Auditor Reporting Standard Appendix 3	Appendix 3 contains certain example reports from the Interim Standard AU 508 that have been updated for the new proposed auditor reporting standard. We suggest that the PCAOB review these examples to determine the applicability in an issuer environment and to reflect the SEC's reporting requirements. For example:  AU 508.34 is for a balance sheet-only report
		AU 508.44 is for a situation when management declines to present a basic financial statement
		<ul> <li>Various qualified, adverse and disclaimer opinion reports are presented (in the Appendix as well as in the Amendments to AU 9508)</li> </ul>
		Examples refer to the Introductory paragraph of the new standard, which reflects a 3-year period for the results of operations and cash flows, but the examples provide an opinion paragraph that reflects a 2-year period for the results of operations and cash flows

13	Auditor Reporting Standard Appendix 3	Although the proposed auditor reporting standard does not require a certain order to the paragraphs of the auditor's report, we suggest that the PCAOB consider updating the examples to prominently present the opinion paragraph. The auditor's report length will significantly increase as a result of this new standard. Prominently presenting the opinion paragraph will help investors and other financial statement users readily determine the type of opinion issued.
15	Amendments to PCAOB AU 9508.36	We suggest that the PCAOB determine that the example provided for a report on single-year financial statements in the year of adoption of the liquidation basis is in conformity with ASU 2013-07, <i>Presentation of Financial Statements</i> (Topic 205), or provides clarification on the portions of the report related to the stub-period that are not required by that ASU.
16	Amendments to PCAOB AU 9508.83 and .84	These qualified and adverse opinion examples appear to relate to a non-registered investment partnership. We suggest that the PCAOB challenge the appropriateness of these examples.