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December 23, 2013

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

Re: PCAOB Release No. 2013-005; Rulemaking Docket Matter No. 034;
Proposed Auditing Standards – The Auditor’s Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor’s Report; and Related Amendments to PCAOB Standards

Ladies and Gentlemen:

The Public Company Accounting Oversight Board (the “Board” or “PCAOB”) has solicited public comment on two proposed auditing standards and other matters discussed in PCAOB Release No. 2013-005 (the “Release”) dated August 13, 2013. We appreciate the opportunity to comment on the Release and the important issues it raises.

I. Introduction

We welcome the Board’s continued efforts to make the financial statements and the related auditor’s report more relevant to investors. As we discussed in our prior comment letter in respect of PCAOB Release No. 2011-003, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (June 21, 2011) (the “2011 Release”),¹ our perspective on these matters is informed by our role as legal advisers that represent issuers and others in connection with a wide variety of matters. These matters include advising issuers on their reporting obligations (including

¹ Comment letter of Cleary Gottlieb Steen & Hamilton (Oct. 14, 2011) (the “2011 Comment Letter”), available at http://pcaobus.org/Rules/Rulemaking/Docket034/149_Cleary_Gottlieb.pdf.

financial disclosures); advising issuers and underwriters in connection with a wide variety of capital markets transactions; and advising issuers, investors, acquirors, financial advisors and others in various corporate transactions. Financial reporting, including its reliability and relevance, is often a critical element of these matters, and our involvement requires us to be intimately familiar with (and, frequently, closely involved in) the financial reporting process.

The Board's two proposed auditing standards set out in the Release would significantly affect the role that auditors play in providing information about public companies to investors and other users of financial statements. The proposed standards are, first, a standard addressing the auditor's report on an audit of financial statements (the "proposed auditor reporting standard"), which would modify the content and format of the existing auditor's report and would, in particular, require the auditor to provide information with respect to both "critical audit matters" and its evaluation of "other information"; and second, a standard addressing the auditor's responsibilities regarding "other information" in certain documents that contain audited financial statements (the "proposed other information standard"), which sets out the responsibilities an auditor would have to review and evaluate such other information.

As we stated in the 2011 Comment Letter, in all of the contexts in which we consider financial reporting matters, we are dedicated to the full and fair disclosure – including, in particular, financial disclosure and reporting – called for by the federal securities laws, transparency to investors and markets, and the improvements in financial disclosure and reporting that are fostered by the application of robust auditing standards by independent external auditors. Like the 2011 Release before it, the Release identifies the investment community's concern that auditors may possess information that is useful to investors and other financial statement users that is not communicated in the existing auditor's report. And we believe that attempting to improve the relevance of the disclosures made by auditors continues to be a laudable objective.

As we separately noted in the 2011 Comment Letter, however, we also strongly believe the Board should keep in mind several important principles when considering any changes to the auditor's report and the processes and interactions that may result from those changes:

- First, any change to the auditor's role or report must have a significant probability of improving financial reporting or investors' understanding of an issuer's financial reporting;
- Second, if there is additional original information regarding an issuer that should be disclosed, that disclosure should be the responsibility of, and should come from, the issuer and not the auditor or any other third party;
- Third, any change to the auditor's reporting model should not adversely impact the relationship and the structure of interactions among management, the audit committee and auditors as they have developed since the enactment of the Sarbanes-Oxley Act of 2002 and the related implementation of regulations and standards adopted by the Securities and Exchange Commission (the "Commission") and the PCAOB;

- Fourth, while the Board is seeking to enhance the value of the auditor's report, the importance of the current pass/fail model should not be underestimated, and any changes to the auditor's report should not undermine the pass/fail model; and
- Fifth, the benefits of any path pursued by the PCAOB should outweigh the costs.

For various reasons, we are concerned the proposed auditor reporting standard, while in some ways representing an improvement from certain of the possible approaches discussed in the 2011 Release, continues in certain important respects to depart from these principles. The proposed other information standard – which goes significantly beyond the audit standard currently applicable to such information – raises particular concerns for a number of reasons, including an uncertain benefit to investors, ambiguous scope, increased costs and heightened litigation risk. We describe our concerns with both proposals in greater detail in Section II below. In Section III below, we propose an alternative to the proposals, which we request the PCAOB consider rather than adopting the standards as proposed. In particular, we believe revising the auditors' reporting model to encompass a review of what issuers disclose regarding critical accounting policies and estimates would, as discussed in Section III, be of far greater value to investors; preserve the primacy of issuer, rather than auditor, disclosures; avoid undermining the value of the pass/fail model; create fewer liability concerns; and be much less costly to implement.

II. The Proposed Audit Standards Raise a Number of Significant Concerns

We are concerned the Board's two new auditing standards, as proposed, would have a number of serious, negative implications for auditors, issuers and, in some cases, even users of financial statements. These concerns relate to, among other things: the likelihood an auditor would be required to provide additional original information about the issuer, including immaterial or unnecessarily prejudicial disclosures, in responding to the proposed standards; undermining the existing pass/fail auditor's report model; chilling communications between an issuer's auditor and its management and audit committee; potential confusion among users of financial statements as to the scope and materiality of any new disclosures; heightened litigation exposure for both auditors and issuers; and the likelihood of significantly increased costs without commensurate benefits in terms of more meaningful financial reporting.

A. The Proposed Auditing Standards Would Represent a Significant Expansion of Existing Disclosure Regarding Issuers that Would Be the Auditor's, Rather than the Issuer's, Responsibility and, Worse Still, Would Require Disclosures that May Not Be Material to Investors or Are Unduly Prejudicial to the Issuer.

One of our greatest concerns with the proposed standards is that, as proposed, they would require the auditor to disclose, and to be the source of, a significant amount of additional original information about an issuer. Indeed, this would appear to be an unavoidable consequence of the proposed requirement to include in the report information regarding critical audit matters. By contrast, under the existing auditor reporting model, original disclosures by an auditor (for example, a qualified opinion or an attestation that internal controls over financial

reporting are not effective) generally occur only if an issuer has not complied with accounting principles or disclosure requirements.² Any change to the auditor reporting model should, we believe, otherwise keep the responsibility for disclosure about an issuer where it belongs, with the issuer.³

In addition, we are concerned that, as specifically contemplated by the Release, the additional disclosures an auditor would be making may be either not material to investors or unnecessarily prejudicial to issuers. In the Release, the Board stated that describing considerations around a critical audit matter could require the auditor to disclose “information about the audit or the financial statements that otherwise would not be required to be disclosed by either the auditor or the company under existing auditor reporting standards or requirements of the applicable financial reporting framework.”⁴ This result would be unfortunate. It would result in required disclosure by auditors (rather than issuers) not simply of information about issuers, but of information about issuers that may be neither material nor statutorily required, and that should not be required to be disclosed *by anyone* under *any* requirement, including a PCAOB standard.

1. Information Disclosed Pursuant to the Proposed Auditor Reporting Standard May Not Be Material to Investors.

Issues relating to “new” disclosures being made by the auditor will unavoidably arise insofar as the proposed auditor reporting standard requires the communication in the revised auditor’s report of “critical audit matters.”⁵ As stated in the Release’s proposed definition of critical audit matters, that disclosure would focus on the matters the auditor addressed during the relevant audit that involved the most difficult, subjective or complex auditor judgments, or posed the greatest difficulty to the auditor in obtaining sufficient appropriate evidence or in forming its opinion on the financial statements. Paragraph 9 of the proposed auditor reporting standard sets out a non-exclusive list of factors the auditor would need to take into account when determining whether a matter is a critical audit matter.

But the importance or materiality of an audit matter to what is reported in the issuer’s financial statements is not specified as a factor in determining whether an audit matter is significant or critical. Indeed, most of the factors specified in proposed paragraph 9 relate to matters having to do with the audit process generally, rather than matters related to the significance of the impact of the audit matter on the financial statements.⁶ As a result, under the

² We believe the “going concern” qualification, which can be original information in an auditor’s report, is anomalous and in any event should not be viewed as the basis for wholesale inclusion of additional original information in an auditor’s report.

³ As we noted in the 2011 Comment Letter, the Treadway Commission’s 1987 report squarely placed the primary responsibility for an issuer’s financial statements on management, and made clear that independent public accountants play a secondary role.

⁴ Appendix 5 of the Release, p. A5-42.

⁵ For the reasons set out in Section II.D below, we think auditors will rarely if ever make “new” substantive disclosures about the issuer under the proposed other information standard.

⁶ For example, the proposed factors include the degree of subjectivity involved in determining or applying audit procedures, the nature and extent of audit effort required and the nature and amount of available relevant and reliable evidence, as well as matters such as the extent of specialized skills needed to apply audit procedures and the nature of consultations outside the audit engagement team. Release, p. A1-7.

proposed definition, matters may be determined to be critical audit matters that are not material – and may not even be particularly meaningful – to the financial reporting or other financial disclosure of the issuer. It may not even be possible for an investor to distinguish whether a critical audit matter is, in fact, material from the issuer’s standpoint.⁷

An appropriate “fix” for this consequence of the proposal would be to require explicitly in the process for identifying critical audit matters that the auditor consider the materiality of the impact of the audit matter on the issuer’s financial statements and other financial disclosure, and conclude the audit matter relates to material elements of that disclosure, in order to be a critical audit matter. Such a change would not, however, address the broader point regarding auditor disclosure of original information about issuers.

2. *Information Not Otherwise Required to Be Disclosed or that May Be Unduly Prejudicial to Issuers Could Be Disclosed by Auditors Pursuant to the Proposed Auditor Reporting Standard.*

Regardless of whether a particular piece of information currently held by the auditors might in some way be probative, we believe disclosure of that information by the auditor should not be required if that disclosure would be more harmful or prejudicial to the issuer than its probative value. The Release states explicitly – and illustrates, via PCAOB-prepared sample disclosure – that an auditor may be required to make new disclosures beyond those mandated under the current financial reporting framework, including disclosures that apparently run contrary to current regulatory intent. We believe this would be an unfortunate and inappropriate result.

In Hypothetical Auditing Scenario #3,⁸ the issuer has experienced a control deficiency less severe than a material weakness. The sample disclosure of the critical audit matter explicitly references that deficiency, stating that “...it was necessary [for the auditor] to expand the planned audit procedures due to a control deficiency less severe than a material weakness Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee.”⁹ The current rules of the Commission and those of the PCAOB, however, do not contemplate disclosure by an issuer (or an auditor) of a significant deficiency (or any other control deficiency not rising to the level of a material weakness). In fact, when proposing to define “significant deficiency,” the Commission noted that “[t]he purpose of management’s obligations with respect to significant deficiencies ... is to disclose those matters relating to [internal control over financial reporting (“ICFR”)] that are of sufficient importance that they should be reported to the external auditor and to the audit committee so that these parties can more effectively carry out their respective responsibilities with regard to the company’s financial reporting, but which do not require disclosure to

⁷ We believe it likely that, under the proposed standard, even if a critical audit matter addresses immaterial aspects of financial reporting, both issuers and auditors will prefer the auditor not be the sole source of the information disclosed in the auditor’s report, which in many cases may lead issuers to revise their disclosures to include a discussion of any matter identified as a critical audit matter, regardless of materiality.

⁸ Appendix 5 of the Release, p. A5-74 *et seq.*

⁹ Appendix 5 of the Release, p. A5-78.

investors. (*Emphasis added.*)”¹⁰ The Commission’s expressed intent under the ICFR disclosure framework is that a control deficiency that rises only to the level of a significant deficiency is not required to be disclosed in a company’s public filings. That conclusion is entirely consistent with the overall tenor of the discussions around ICFR disclosure, that public disclosures be limited to material weaknesses to avoid conflating material and immaterial disclosures to investors. The proposed auditor reporting standard would, however, apparently represent a “back door” requirement of the PCAOB for disclosure contrary to a settled disclosure policy. Further, there is no reason the same approach suggested in Scenario #3 would not be applied to a control deficiency that does not represent even a significant deficiency, the disclosure of which would be even less likely to be consistent with existing rules. By going beyond the approach reflected in the current requirements, this result would risk the same conflating of material and immaterial matters that has heretofore appropriately been avoided. And this auditor disclosure requirement about an issuer’s ICFR would be imposed even if the issuer itself had determined the disclosure was unnecessary.

Another example where the proposed disclosure of a critical audit matter could add to the mix of information about an issuer that is publicly available, but in a way that is more prejudicial to the issuer than probative, is in the context of disclosures around potential loss contingencies. Under the current standard set forth in Financial Accounting Standards Board (“FASB”) Accounting Standards Codification Topic 450 and related FASB interpretations, a company must accrue a liability for a loss contingency if available information indicates it is probable a loss has been incurred and the amount of the loss can be reasonably estimated. If the estimate is a probable range of loss, the best estimate within that range (or, in some cases, the minimum amount in the range) must be accrued. Recent proposals to update this standard were widely debated and roundly criticized for failing to adequately take into account the realities of today’s litigation environment, because they required a company to disclose quantitative and qualitative information that could be highly prejudicial to its litigation posture.¹¹ The process of auditing loss contingencies often involves difficult, subjective or complex auditor judgments, and privilege and other concerns can pose challenges for issuers in providing evidence relating to determinations about loss contingencies made by issuers. At the same time, however, the very same issues that were raised by the recent FASB proposal would apply to the disclosures an auditor might be required to make in explaining in its auditor’s report why this determination is a critical audit matter. Indeed, the proposed auditor reporting standard will likely raise additional concerns, because it might require (or be interpreted as requiring) an auditor to describe loss contingencies for which the issuer had determined neither an accrual nor disclosure of reasonably possible loss was required.

¹⁰ SEC Rel. No. 33-8811; 34-55930, p. 5 (June 20, 2007). In the related adopting release, the Commission stated that “[i]n proposing the definition, we believed that the focus of the term ‘significant deficiency’ should be on the communications required to take place among management, audit committees and independent auditors.” SEC Rel. No. 33-8829; 34-56203, p. 9 (Sept. 10, 2007). The PCAOB’s relevant Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, similarly requires the auditor to communicate any significant deficiencies identified only to the audit committee.

¹¹ See, e.g., FASB, Exposure Draft, Proposed Accounting Standards Update, Contingencies (Topic 450), Disclosure of Certain Loss Contingencies, File Reference No. 1840-100 (July 20, 2010), and the summary of the 339 comment letters received on the proposal published by the FASB as of October 26, 2010, both available on the FASB’s website at www.fasb.org.

The auditor reporting standard as proposed thus has the potential to (or, more accurately, is designed to) require an auditor to disclose original information about an issuer, even if that information may only be relevant to the audit process and not material to the financial statements or other financial reporting of the issuer or is otherwise too prejudicial to the issuer to justify incremental disclosure.

B. Disclosure of Critical Audit Matters Will Necessarily Undermine the Pass/Fail Nature of the Current Auditor's Report.

The negative, though speculative, implications of the new critical audit matter disclosure will necessarily undermine the pass/fail nature of the current auditor's report. Although the Release makes clear that auditors are prohibited from including language in their reports that could be viewed as disclaiming, qualifying, restricting or minimizing the auditor's responsibility for matters deemed critical audit matters, or on the auditor's opinion regarding the financial statements, it is far from clear how that would work in practice or whether it would address our concern regarding preservation of the value of the pass/fail model. If, for example, a critical audit matter involves a valuation requiring an exceptional amount of professional judgment and few (or no) clearly identifiable data points, should that be viewed as an appropriate description of the circumstances surrounding the identification of a critical audit matter, or would it be viewed as a disclaimer?

In short, we are concerned the discussion of critical audit matters is likely implicitly to qualify the pass/fail nature of the current auditor's report, by calling into question the reliability of the information that is the subject of a company's critical audit matters. Notwithstanding the uncertainty as to what these disclosures would mean, they can be expected at least to convey that caution (whether warranted or not) should be applied regarding financial disclosures that were difficult to verify.

C. Disclosure of Critical Audit Matters May Weaken Comparability of Disclosures Among Issuers and Inappropriately Shift Investor Focus.

The inherent variability in the number, subject matter and, most importantly, materiality of the critical audit matters disclosed by each issuer may cause investors to focus unduly on those matters and to inappropriately compare issuers on the basis of whether and the extent to which those matters have been identified. Because each critical audit matter would be determined based on unique facts and circumstances, disclosures may vary significantly between an issuer and its competitors, or from period to period with respect to the same issuer. Even when the same critical audit matter is identified across multiple issuers, there may still be no way to determine whether such a matter is material to some, none or all of them, or merely involves a similar set of difficult-to-determine factors driving the criticality determination. Again, notwithstanding the uncertainty as to the meaning of these disclosures, we are concerned about the provision to investors of information in the auditor's report that calls comparability into question, whether or not these distinctions are significant (and, indeed, the distinctions are in the last analysis necessarily insignificant in importance where the auditor provides an unqualified opinion).

D. The Requirement to Disclose Critical Audit Matters May Chill Auditor/Board Communications.

As described in greater detail above, the proposed auditor reporting standard would potentially require the auditor to disclose “new” information about an issuer that management has affirmatively chosen not to disclose and is not otherwise required to be disclosed under the securities laws or the Commission’s regulations. Such information may be quite sensitive. Anything that risks interfering with the most open and robust communications among management, audit committees and auditors would be to the detriment of the relationship between issuers and auditors, and ultimately potentially to the detriment of investors. We strongly believe maximizing the openness of communications between management, audit committees and auditors is more likely to produce better financial reporting and disclosure than the questionable benefits of the additional disclosure provided by the proposed standard.

E. The Proposed Other Information Standard Generally Will Not Give Rise to Additional Disclosure; Not Enable Financial Statement Users to Know What Information Has Been Evaluated; and Requires Auditors to Pass On Matters Outside the Scope of their Expertise.

The proposed auditor reporting standard would require disclosure of the auditor’s responsibility for, and evaluation of, certain other information,¹² pursuant to the proposed other information standard. This would represent a significant departure from the current auditor’s report, which only requires the auditor to express an opinion as to whether the financial statements present fairly, in all material respects, the financial position of the company in conformity with generally accepted accounting principles. The proposed standards, by contrast, would require the auditor to expressly state both that it had evaluated the other information and whether or not it has identified any material inconsistency with the financial statements or material misstatement of fact.¹³ But the likely result in almost every circumstance will be the same as under the current standard – if auditors have concerns about disclosure, they will discuss them with issuers; issuers, which can revise their disclosures at any time before the auditor issues its report, will make such changes, if any, as are appropriate; and the auditor’s report will state that no such item has been identified, thus requiring no additional disclosure to be made by the auditor.

¹² “Other information” is defined in the Release to include information (other than the audited financial statements and the related auditor’s report, but including certain specified information that is incorporated by reference) included in a company’s annual report filed with the Commission under the Securities Exchange Act of 1934 (the “Exchange Act”) (*i.e.*, its Form 10-K, Form 20-F or similar form). The Release notes, however, that this evaluation is based on “relevant evidence obtained and conclusions reached during the audit.” Release, p.7. Accordingly, if such “other information” is not directly related to the audited financial statements, is non-financial in nature or is related to the company’s operations, the auditor may not have obtained evidence or reached any conclusion regarding that information during the audit – and, accordingly, would not be required to reach any conclusion with respect to it.

¹³ Under the proposed standard, if the auditor has identified a material inconsistency with the financial statements or a material misstatement of fact, it must discuss the issue with management and may, depending on management’s response and the circumstances of the statement or inconsistency, be required to advise the audit committee; consider any obligations it may have under Section 10A of the Exchange Act; withdraw from the audit engagement; or include appropriate disclosure in its auditor’s report.

This change would, we believe, adversely impact the current auditor reporting model, with no likely benefit for the reasons stated above. Existing AU Section 550, *Other Information in Documents Containing Audited Financial Statements* (“AU 550”), already provides a sufficient check by the auditor on inaccurate disclosure and strikes an appropriate balance by requiring the auditor to read and consider the “other information” contained in issuer filings and, if it identifies concerns regarding that information, to report those concerns to management (and, if necessary, the audit committee, or, in particularly problematic cases, to consult with counsel or withdraw from the audit engagement). But AU 550 does not require the auditor to notify third parties of any concerns it may identify, nor does it place the auditor in the role of “evaluating” non-financial information. And since the auditor communicates its findings under AU 550 only to the issuer, the current standard has no need to define “other information” or to distinguish between financial and non-financial information (nor does it attempt to do so).

1. As a Practical Matter, the Proposed Other Information Standard Will Rarely if Ever Give Rise to Additional Disclosure.

The Release makes clear that an auditor may state it has not identified a material inconsistency with the financial statements or a material misstatement of fact in the other information in circumstances where the auditor identifies something in the course of the audit process and management subsequently makes what the auditor considers appropriate revisions before the auditor’s report is issued.¹⁴ In reality, therefore, in all but the most extreme cases the auditor will be in a position to state that no material inconsistency or material misstatement has been identified at the time the auditor’s report is issued. Auditors and issuers will work together to rectify any errors that may be uncovered (as they do today in connection with inconsistencies or misstatements identified in connection with the procedures required under AU 550). As a result, in few if any cases will the proposed other information standard result in additional information for investors.

2. Investors Will Have No Way to Determine What “Other Information” in an Issuer’s Filings Has Been Evaluated by the Auditor.

Because, as noted above, the proposed standard contains an unnecessary public disclosure requirement, it becomes necessary to define “other information,” but the proposed definition of “other information” is broad, vague and non-specific.¹⁵ The precise contours of the other information the auditor is actually evaluating will be, at best, extremely opaque to investors (apart from the obvious, *e.g.*, selected financial information, or recitals of GAAP financial data). The Release notes several less-obvious disclosures that could be covered in certain circumstances – such as statements about the company’s competitive environment, technological developments, or supplier relationships – and describes a situation where the auditor might have knowledge, based on relevant audit evidence obtained during the audit, that contrary to a company’s claims it does not have the largest market share in its industry. In each such case, however, the auditor’s knowledge will necessarily derive from the facts and circumstances of a particular audit, which will of course vary from issuer to issuer, and may even vary from year to

¹⁴ Release, Appendix 6, p. A6-33; paragraph 13.e of the proposed other information standard.

¹⁵ See note 11 above.

year for the same issuer. Due to these variables, it will be impossible for investors to determine the extent to which “other information” in an annual report has actually been evaluated.

Take the market share example described in the Release.¹⁶ For the sake of the following discussion, let us assume the issuer’s market share disclosure is material. If a competitor of the issuer makes the same (incorrect) claim, but contrary information is not part of the audit evidence obtained by its auditor (and there is no reason, in our view, to expect that such information will necessarily be obtained by an auditor, unless the auditor would be expected, contrary to even the proposed standard and at even greater expense, to collect evidence related to “other information” as part of the audit), then, in that case, the statement is not subject to evaluation, even though the second auditor makes exactly the same recitation as the first auditor as to “other information” generally. Similarly, there could be different results of the evaluation of other information in different years, depending on information obtained. Another example might involve a comparison of a plant’s actual production against its production capacity. An auditor might be able to determine, based on audit evidence, what goods a factory actually produced during a given year, but at the same time have no audit-evidence-based knowledge of the plant’s capacity.

This concern as to whether a user of financial statements could determine whether particular statements are, or even could be, evaluated by the auditor – where the answers may vary significantly based on factors invisible to those users – is real and troublesome. Moreover, this concern is not necessarily isolated but could extend to every item of information included in the relevant filing.¹⁷

3. *Any Requirement to “Evaluate” Other Information Beyond Financial Information Would Exceed Auditors’ Expertise.*

One of the significant issues auditors would face in applying the proposed other information standard with respect to information other than financial information is whether doing so is consistent with the auditor’s role and core expertise. As we noted in our 2011 Comment Letter, auditor expertise centers on financial information, financial reporting, auditing and related matters, and generally does not extend to evaluating business strategy and trends, analyzing risk (other than risks regarding financial reporting) or predicting future performance. The Release does not go as far as the 2011 Release in suggesting as a possible approach that auditors affirmatively attest to the content of MD&A or information contained elsewhere in a company’s annual report. We believe, however, that if auditors are required to do more than, at most, evaluate specified financial information disclosed in the annual report, that would increase audit costs while appearing to provide comfort regarding accuracy that is unjustified.

4. *The Proposed Standard Is Not Consistent with the Procedures Applied by Auditors in Connection with Comfort Letters.*

¹⁶ Release, p. A6-13.

¹⁷ One way the Board might try to narrow the proposed standard would be to limit “other information” to information contained in or derived from the issuer’s financial records. This would allow auditors to focus their evaluation efforts, rather than taking a costly, scattershot approach, while benefitting investors by enabling them to determine what information the auditor had (and, more importantly, had not) evaluated. This, however, would not by itself address our concerns with the proposed standard.

The proposed standard would also represent a significant departure from procedures an auditor would perform under AU Section 634, *Letters for Underwriters and Certain Other Requesting Parties* (“AU 634”), in connection with a comfort letter provided to an underwriter in connection with an offering of securities. In that context, with respect to information that would be “other information” under the proposed standard, the auditor performs limited procedures only on information identified specifically by the underwriter, rather than performing procedures generally on all such information. And the content of each comfort letter, and the procedures performed on particular disclosure items, is frequently the subject of significant negotiations between the underwriter and the auditor, and in all events is limited to information derived from the company’s books and records that are subject to an ICFR framework.

F. The Proposed Auditing Standards Are Likely to Heighten Litigation Exposure for Both Auditors and Issuers

Another significant concern raised by both proposed standards is the cost imposed on both auditors and issuers in terms of heightened litigation exposure under the securities laws. The proposed other information standard, in particular, will significantly increase litigation exposure by requiring auditors to make an affirmative statement as to their findings, even in cases where nothing has been found. We emphasize that we are not merely raising the generalized concerns regarding auditor liability, or increases therein, that are often raised in discussions of the role of the auditor in public company financial reporting and audits. Rather, the proposed new standards, because of the combination of additional affirmative statements by auditors, the possible applicability of the *Janus* decision discussed below, and the possible implications of the proposal in respect of liability under the Securities Act of 1933 (the “Securities Act”), raise specific and serious issues we discuss more fully below.

1. There Is a Significant Likelihood the Potential for Auditor Liability Would Increase Due to the Proposed Audit Standards.

Under the federal securities laws, auditors face potential liability under various statutes, including in particular Sections 10 and 18 of the Exchange Act and Section 11 of the Securities Act. One of the claims most frequently made against auditors is under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Under those provisions, an auditor can be liable if it makes a statement in its auditor’s report that is misleading when made and the requisite scienter standard is met. The proposed audit standards require auditors to make several new statements in connection with their auditors’ reports, including a statement as to whether or not the auditor has identified any material inconsistencies with the financial statements or material misstatements of fact in the other information included or incorporated by reference in the relevant annual report, as well as statements identifying critical audit matters.

The requirement under the proposed other information standard that the auditor make a public statement it has affirmatively evaluated the other information but did not discover any such inconsistencies or misstatements seems particularly problematic, both because the required evaluation procedures have the potential to involve a significant volume of evidence – including evidence that may or may not be related to financial statements or financial reporting –

and because the scope of “other information” is inherently broad and uncertain.¹⁸ As a result, any qualitative statement relating to information as to which an auditor might have developed evidence during the course of the audit process has at least the potential to become the subject of a lawsuit. And because the auditor is making an affirmative statement, under the Supreme Court’s decision in *Janus Capital Group, Inc. v. First Derivative Traders*,¹⁹ the auditor could be subject to a private right of action under Rule 10b-5 predicated on the material inaccuracy of its statement, to which it would not have been subject had the statement, as under AU 550, been made only to the issuer. While it might be possible to attempt to distinguish the inclusion of this statement in the auditor’s report on several grounds (including that the report would indicate the other information was not audited and the auditor was not expressing an opinion on it), there is no certainty that would be the case and even less likelihood that the auditor would entirely avoid litigation as a result.

Under the proposed auditor reporting standard, the auditor would similarly be required to make a number of publicly available additional statements in its auditor’s report. In particular, the auditor would be required to identify the critical audit matters associated with the audit.²⁰ The disclosure (or non-disclosure) of these matters could create significant opportunities for a plaintiff to bring suit against an auditor following the revelation of a misstatement or omission that, particularly in hindsight, can be alleged to have been material. If the underlying issue relates to a critical audit matter, but was not discovered, the plaintiff may assert the auditor was reckless in not discovering the issue. If the underlying issue relates to a matter that was not considered as having the potential to be a critical audit matter, the plaintiff may assert the auditor was reckless in failing to identify the critical audit matter in question. Or, finally, if the underlying issue relates to a matter the auditor considered as a possible critical audit matter, but where it affirmatively determined the matter was not critical, the plaintiff may assert that determination was itself reckless.

In light of the heightened risk of litigation, another aspect of the proposed auditor reporting standard that should be reconsidered is the requirement for the auditor to retain audit documentation with sufficient information to enable an experienced auditor who has no previous connection with the engagement to understand the basis for the auditor’s determination that each non-reported audit matter that would appear to meet the definition of a critical audit matter was, in fact, not a critical audit matter. While the Board notes several reasons why this would be important to the process of determining critical audit matters (including enabling the PCAOB inspection staff to determine whether this aspect of the proposed new standard is being properly implemented), it also creates (and requires an auditor to retain) a detailed documentary record of the auditor’s determination that a matter was not “critical.” If this would require an auditor to retain work papers or materials beyond those that would have been separately required to document the auditor’s audit determinations, this requirement would seem to accomplish little of

¹⁸ See note 11 above.

¹⁹ 131 S. Ct. 2296 (June 13, 2011).

²⁰ We note the proposed auditor reporting standard would also require auditors to make affirmative statements regarding a number of other matters, including that it is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company, and the year that it began serving as the company’s auditor. Because these are more focused, factual statements about matters with which the auditor is readily familiar, they do not raise a liability concern.

benefit to investors while giving rise to increased litigation risk with respect to any “identified but not determined to be critical” matter.

2. *As Proposed, the Standards Appear to Create at Least Some Potential for Liability under the Securities Act.*

Both the proposed auditor reporting standard and the proposed other information standard appear to have the potential to increase auditors’ liability exposure with respect to offerings conducted under the Securities Act. The more difficult analysis of this question, however, involves the proposed other information standard. The Release explicitly notes that, consistent with existing AU 550, the proposed standard would not apply to documents that are filed with the Commission under the Securities Act, and that an auditor’s responsibilities with respect to Securities Act filings are governed by its responsibilities under Section 11 of the Securities Act and AU Section 711, *Filings Under Federal Securities Statutes*.

But while the Release discusses in some detail various obstacles to applying the reporting requirements under the proposed other information standard to documents filed under the Securities Act, in our view the Release does not squarely address the implications for incremental auditor liability that arise from including the additional information required by the proposed audit standards, particularly with regard to other information, in auditors’ reports incorporated by reference from annual reports into registration statements (including, but not limited to, liability for that information as an “expert” under Section 11 of the Securities Act, if that additional information is viewed as having been expertized). This is currently not of concern under AU 550 because, as noted in Section II.E above, that standard does not require the auditor to communicate the results of its work to any person other than the issuer. While the PCAOB may not intend to impose expert liability on the auditor with respect to the auditor’s statement regarding other information, and also may not intend to impose such liability on the descriptions of critical audit matters under the proposed auditor reporting standard, that will not necessarily be the uniform outcome if the issue is widely litigated, as could be the case.

3. *Any Expansion of Required Addressees of the Auditor’s Report Is Inappropriate Given the Increased Litigation Exposure.*

The Board also asked, in connection with the proposed auditor reporting standard, whether (and the extent to which) the list of persons to whom an auditor’s report is addressed should be expanded. In the Release, the PCAOB noted that many auditors currently address their reports to an issuer’s shareholders (as *permitted* under the existing audit standard). The proposed standard, however, would require the report be addressed, at a minimum, to “investors in the company, such as shareholders” and would require auditors to determine whether any non-equity investors are appropriate addressees.²¹

Under various circumstances, an auditor currently may be liable to a third party with whom it does not have a contractual relationship in respect of the statements it makes in its auditor’s report, although in at least some cases that determination may require the third party to demonstrate the auditor knew, or should have known, the third party was relying on its report or

²¹ Release, p. A5-9.

on the related financial statements.²² There are, however, currently at least some situations where an auditor is less likely to be liable to others, including in the case of mere negligence.²³ Expanding the pool of addressees to include non-equity investors would have the effect of increasing the potential liability of auditors by expanding the number of persons able to demonstrate they were entitled to rely on the report in those contexts. Moreover, while the existing reporting standard *permits* auditor reports to be addressed to shareholders, in light of the increased risk of auditor liability if the proposals are adopted, we anticipate auditors would likely wish to address their report solely to the issuer and its board of directors.

III. An Alternative Approach for Consideration – Auditor Evaluation of Critical Accounting Policies and Estimates

In Section II, we have highlighted our concerns regarding the proposed standards, including in particular that an auditor will unavoidably be required to disclose original additional information about an issuer, including immaterial or unnecessarily prejudicial information; the revised auditor’s report would undermine the existing pass/fail model; the procedures required by the proposals could chill communications between auditors, management and audit committees; the proposed other information standard would generally give rise to no new disclosure while simultaneously giving rise to uncertainty among investors; and heightened litigation exposure. We believe these concerns can largely be eliminated if, instead of the current proposals, the PCAOB modified its approach and auditors were asked to provide a supplemental statement regarding an issuer’s disclosures relating to critical accounting policies and estimates.

Disclosure by issuers of critical accounting policies and estimates in their MD&A is now almost universal. Nonetheless, as referenced in the 2011 Comment Letter, we believe enhancing disclosure by issuers of the impact of accounting estimates and judgments on their financial statements and reporting may be desirable. Each issuer’s financial reporting framework includes a significant number of estimates that could cause results to vary significantly; rarely if ever are these matters discussed in detail in an issuer’s financial statements or other reporting.²⁴

In the 2001 Guidance, the Commission suggested issuers should disclose in the MD&A the “accounting policies that management believes are most ‘critical’ – that is, they are

²² See, e.g., *Credit Alliance Corp. v. Arthur Anderson & Co.*, 483 N.E.2d 110 (N.Y. 1985); *Utramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931). Under these and other, similar cases, an auditor typically has a duty to a non-client if (i) the auditor was aware the report was to be used for a particular purpose; (ii) a known third party was intended to rely on the report to further that purpose; and (iii) some conduct by the auditor links it to the third party.

²³ See, e.g., Restatement (Second) of Torts: § 552, Information Negligently Supplied for the Guidance of Others, comment h (1977) (“The rule stated in this Section subjects the negligent supplier of misinformation to liability only to those persons for whose benefit and guidance it is supplied. In this particular his liability is somewhat more narrowly restricted than that of the maker of a fraudulent representation, which extends to any person whom the maker of the representation has reason to expect to act in reliance upon it.”).

²⁴ The Commission’s guidance to date in this area includes the following: two releases discussing critical accounting policies in December 2001 (SEC Rel. No. 33-8040; 34-45149 (Dec. 2001)) (the “2001 Guidance”) and January 2002 (SEC Rel. No. 33-8056; 34-45321 (Jan. 2002)) and guidance on critical accounting policy disclosure in its December 2003 interpretive release on MD&A (SEC Rel. No. 33-8350; 34-48960 (Dec. 2003)) (the “2003 Guidance”). The Commission also proposed rules on critical accounting policies in May 2002, but has not adopted them. SEC Rel. No. 33-8098; 34-45907 (May 2002) (the “2002 Rule Proposal”).

both most important to the portrayal of the company's financial condition and results, and they 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."²⁵ The Commission noted that both the issuer's management and its auditor should "bring particular focus" to evaluating the critical accounting policies. Subsequently in the 2003 Guidance, the Commission also focused on materiality, noting issuers should disclose in their MD&A "accounting estimates or assumptions where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and assumptions on financial condition or operating performance is material."²⁶ The Commission went on to say issuers "should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors. (*Emphasis added.*)" In addition, as the Commission separately noted in its 2002 Rule Proposal, an issuer's auditor is already responsible for evaluating the reasonableness of the accounting estimates made by management in the context of the financial statements taken as a whole.²⁷

We believe the adoption of a narrowly focused auditor review standard in this context could improve issuer disclosure and thus provide greater insight to investors. The auditor could, for example, be asked to provide negative assurance that, based on its work on and evidence compiled during the audit, nothing has come to its attention that causes it to believe (a) the disclosure included in the document that contains financial statements that were subject to the audit fails to address all critical accounting estimates or policies that are required to be disclosed, or (b) the disclosure regarding the critical accounting estimates or policies included in the document is not accurate in all material respects.

This approach would, in our view, represent a significant improvement over the proposed standards. In particular, it would have the benefit of addressing matters that are material to an issuer's financial reporting generally, not to the audit specifically. In addition, it avoids any requirement that the auditor be a source of original disclosure about the issuer, as the auditor would be commenting on issuer disclosure and would not be making additional disclosure (assuming that, if the auditor identifies modifications necessary for the issuer to make in order to meet the requirements, the issuer makes those modifications). It also does not call

²⁵ 2001 Guidance, p. 2.

²⁶ 2003 Release, p. 18. The Commission went on in the 2003 Guidance to suggest that factors issuers might choose to address in this disclosure could include how management arrived at the estimate, how accurate the estimate/assumption had been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future, but noted that these factors should be analyzed "to the extent material." *Id.*

²⁷ See 2002 Rule Proposal, pp. 26-27. See also AU Section 342, *Auditing Accounting Estimates*, paragraph 4 ("AU 342"). In making that evaluation, the auditor must obtain evidence sufficient to provide reasonable assurance that all accounting estimates that could be material to the financial statements have been developed, that those estimates are reasonable in the circumstances and that those estimates are presented in conformity with applicable accounting principles and are properly disclosed. AU 342, paragraph 7. In the 2002 Rule Proposal, the Commission also indicated it was considering whether to adopt a requirement that an independent auditor must examine, in accordance with attestation standards, the MD&A disclosure relating to critical accounting estimates. The Commission has not adopted the 2002 Rule Proposal, and we do not believe there is a need for it to do so at this time.

into question the pass/fail model, as it does not raise any concern about audit judgments, nor does it implicitly raise questions about the reliability of the financial statements. Finally, it requires the auditor to evaluate only accounting matters, rather than other matters that may be beyond the scope of the auditor's expertise, which means it should both be meaningful and more cost-effective to implement.

We strongly believe the problems surrounding both the proposed auditor reporting standard and the proposed other information standard, as discussed in Section II above, effectively mean the risks, costs and uncertainties associated with the proposals outweigh their benefits to investors, and that the new standards should not be adopted as proposed. As an alternative, we strongly encourage the PCAOB to consider our proposal relating to existing critical accounting policies and estimates disclosure, as set out above. In any event, we strongly encourage the Board to address the serious concerns we and other commenters have raised regarding the proposed audit standards to help ameliorate their potentially significant negative consequences before adopting any final standards.

IV. Phase-In Period

The Board has raised, in the Release, the issue of whether and to what extent it would be appropriate to implement a delayed compliance period for either or both of the proposed audit standards (including, for example, whether there should be a delay in the implementation of the proposal for smaller companies). In light of the significant changes the Board is proposing and the various concerns expressed by commenters, we believe a staged or delayed implementation of any adopted proposals would be beneficial, in part because that would permit the PCAOB to adjust the process were issues to arise while new standards were being implemented. The Board might also consider whether a voluntary pilot program covering a relatively small number of larger issuers might be useful in assisting the Board in determining whether there are benefits to the proposed new standards and identifying either general or specific issues during the process.

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We thank you for the opportunity to submit this comment letter. Please do not hesitate to contact Leslie N. Silverman, Alan L. Beller, Nicolas Grabar or James D. Small (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTlieb STEEN & HAMILTON LLP

cc: Public Company Accounting Oversight Board
Hon. James R. Doty, Chairman
Hon. Lewis H. Ferguson, Member
Hon. Jeanette M. Franzel, Member
Hon. Jay D. Hanson, Member
Hon. Steven B. Harris, Member