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Onderwerp: CAQ Comment Letter

Gentlemen,

Hope this finds you both well. I wanted to officially notify you that the CAQ will file our comment letter on IAASB's auditor reporting, via our comment letter to the PCAOB, on the date we file with the PCAOB. You will find that our PCAOB comment letter urges alignment with the IAASB model and that we found much to support in your proposal.

Kindly,
Cindy

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December 11, 2013

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

Dear Office of the Secretary:

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

The CAQ welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (proposed auditor 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 *Related Amendments to PCAOB Standards* (collectively, the proposal). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ is supportive of the PCAOB's efforts to update and enhance the auditor's reporting model to provide additional information in an increasingly complex and global environment. This is an important project of great interest to many different stakeholders and one that will require careful deliberation and extensive outreach to develop an approach that can be practically applied. We commend the Board's consideration of international efforts, in particular those of the International Auditing and Assurance Standards Board (IAASB), in developing the proposal. We also commend the Board for considering the results of outreach conducted and the comment letters received from the CAQ and others, particularly in response to the PCAOB's June 2011 *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release).¹

¹ See the PCAOB's Concept Release ([link](#)).

Over the past three years, the CAQ has shared its perspectives and views on the topic of auditor reporting through comment letters to both the PCAOB and the IAASB.² The CAQ recognizes that enhancing the information communicated by the auditor is a worthy and warranted objective. In response to the PCAOB's proposal, we have initiated a coordinated and collaborative effort with members of the public auditing profession to field-test the proposal in order to help inform our views and our comments to the PCAOB. It will take several months for those members to conclude the field-test and analyze the results, but we hope to share insights next year in advance of the PCAOB's expected Spring 2014 roundtable related to the auditor's reporting model.

We believe that changes of this magnitude present challenges that must be carefully considered. Our suggestions are aimed at addressing such considerations, while helping to achieve the objectives of the Board as articulated in the proposal. In developing our suggested changes, we were guided by a set of principles that we believe are most relevant to the proposal, including:

- Auditors should avoid providing information about the company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure.³
- Any changes to the auditor's reporting model should enhance, or at least maintain, audit quality.
- Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
- Any changes to the reporting model should add value and not create investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.

Among our suggestions, we propose streamlining the auditor's process for determining critical audit matters (CAMs), in part, through leveraging the auditor's existing required communications with the audit committee, and focusing the auditor's determination of CAMs on the most important matters conveyed in such communications. With respect to other information, we suggest that the auditor's report be revised to articulate the auditor's responsibility for other information inclusive of the need to report unresolved material inconsistencies or material misstatements of fact, rather than requiring the auditor's report to contain a specific conclusion. Our suggested changes to the performance requirements related to other information comport with our understanding of the PCAOB's intent in revising the extant guidance, in a cost-effective way. We believe our suggested approach will provide users with a better understanding of the auditor's responsibilities with respect to other information, while creating less incremental litigation risk.

To further the Board's objectives, we also offer a number of suggestions related to the standard language in the auditor's report. We believe such changes will help clarify the report in a number of ways, including more clearly articulating the responsibilities of the auditor, management, and the audit committee, and providing context around important terms such as "reasonable assurance." Finally, as requested by the PCAOB, we discuss the liability risks associated with the proposal, and how our suggested changes to the proposal may help to mitigate these risks. We have organized our suggestions into the following sections:

- I. Critical Audit Matters
- II. Other Information
- III. Auditor Tenure
- IV. Auditor's Unqualified Report and Clarifying Language Changes
- V. Applicability
- VI. Cost-Benefit Considerations

² See CAQ comment letters to the IAASB dated October 8, 2012 ([link](#)) and September 15, 2011 ([link](#)) and the PCAOB dated September 30, 2011 ([link](#)) and June 28, 2011 ([link](#)).

³ Similar views were expressed by stakeholders who participated in the CAQ's "Role of the Auditor" roundtable discussions. See the CAQ's *Observations on the Evolving Role of the Auditor: A Summary of Stakeholder Discussions* ([link](#)).

- VII. Appendices
- A. Illustration of Suggested Changes to the Proposed Auditor Reporting Standard and Examples
 - B. Illustration of Suggested Changes to the Proposed Other Information Standard
 - C. Illustration of an Unqualified Auditor’s Report
 - D. Legal Considerations

We draw your attention to Appendices A through C, which illustrate our suggested changes to the proposed auditor reporting and other information standards, and our suggested clarifying language changes related to the auditor’s report. We stand ready to assist the Board in the coming months as it reviews comments on the proposal, conducts additional outreach, considers the results of field-testing efforts, and deliberates next steps.

I. Critical Audit Matters

Overall Comments

We support the overall efforts of the PCAOB to improve the information communicated to financial statement users through the auditor’s report, and we agree with the PCAOB that CAMs “...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” and “...could enable them to analyze more closely any related financial statement accounts and disclosures.”⁴ We believe that the PCAOB’s proposal represents a constructive approach in this regard. However, there are areas that present important implementation issues that require further consideration. We discuss these areas below, and present suggestions for consideration that we believe could enhance the PCAOB’s proposed approach.

CAM Determination

We note that the PCAOB’s approach for the determination of CAMs includes consideration of matters in the engagement completion document, matters reviewed by the engagement quality reviewer, and matters communicated to the audit committee. We believe that these criteria are overly broad and largely duplicative and would potentially result in an excessive number of CAMs communicated in the auditor’s report. Such an outcome would dilute the significance of the matters identified in the report and be contrary to the PCAOB’s stated intent for the auditor’s report to highlight the matters that were the most important to the audit. We believe matters that are important enough to merit communication with the audit committee represent the appropriate starting point for an auditor’s consideration of CAMs, given the audit committee’s oversight of the audit and role in representing the interests of shareholders. We have suggested additional changes to the proposed determination criteria which we believe will help provide for the identification of the most relevant of these matters.

CAM Communication

We note that paragraph 11 of the proposed auditor reporting standard requires the auditor to describe the considerations that led the auditor to determine that a particular matter is a CAM. The example CAM sections provided in the proposal appear to interpret this requirement to mean that the auditor’s descriptions of each CAM are expected to address each of the specific factors included in paragraph 9 that were present. To the extent this reflects the PCAOB’s intent, this raises several potential issues. First, having to describe each of the particular factors in paragraph 9, such as consultations with the national office or specialists, would obscure the more significant factors in the auditor’s description of why the matter was critical to the audit and may contribute to user misunderstanding. In this regard, we note that events such as consultations with a firm’s national office or engagement of firm specialists may be a response to a challenging audit issue, but are not a factor used in determining that the matter is challenging or critical. Second, the proposal as reflected in the example CAM reporting will likely lead to instances of an auditor providing original

⁴ See the proposal pages A5-22 through A5-23.

information⁵ that is currently not required to be disclosed by the company (e.g., control deficiencies less severe than a material weakness, and corrected and accumulated uncorrected misstatements). This would blur the roles of management and the auditor, and potentially widen the expectation gap.

CAM Documentation

We note that paragraph 14 of the proposed auditor reporting standard requires 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, as it is unclear how an auditor could effectively demonstrate that such matters *are not* CAMs. This documentation requirement may result in auditors communicating a significant number of matters in the auditor’s report, in anticipation of potential second guessing that could occur subsequent to its issuance. We believe this outcome is contrary to the intent of the proposal. In addition, we believe this requirement would add significant costs to the audit process without a corresponding benefit.

Suggested Changes to the Proposed Auditor Reporting Standard

We have developed suggested changes to the proposed auditor reporting standard that we believe will provide for the auditor’s determination and communication of CAMs while addressing the areas noted above. We provide our suggestions and rationale below. Appendix A reflects these suggested changes in paragraphs 7 through 14 of the proposed auditor reporting standard, along with related revisions to the three illustrative examples included in the proposal.

CAM Determination

When determining the matters that represent CAMs, we believe that the auditor should initially identify matters that were significant to the audit of the financial statements (significant audit matters). Such matters would be derived from (and would be a subset of) those matters communicated to the audit committee under PCAOB Auditing Standard No. 16, *Communications with Audit Committees* (AS 16). 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.”

Given the nature of these required communications, we believe that matters required to be communicated to the audit committee pursuant to AS 16 would be an appropriate starting point for the determination of any audit matter that would be important enough to the audit to be a CAM. Additionally, this approach would more closely align the PCAOB’s CAM approach with the IAASB’s *key audit matters* approach, which begins with matters communicated to those charged with governance, and would result in greater global consistency across auditors’ reports.⁶

When determining which matters required to be communicated to the audit committee were significant audit matters, we believe that auditors should take into account the eight factors identified by the PCAOB in paragraph 9 of the proposed auditor reporting standard. The auditor would then need to determine which of the significant audit matters are CAMs, by identifying those matters that, in the auditor’s judgment: a) were

⁵ For the purpose of our response to the Board’s proposed auditor reporting standard, original information is information about a company’s financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company’s management to consider for disclosure.

⁶ See the IAASB’s ED, Proposed ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* (Proposed ISA 701), paragraph 8.

material to the financial statements; b) 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; and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our rationale for determining CAMs in this manner is as follows:

- a) We agree with the PCAOB that CAMs could enable users to focus on certain aspects of the company's financial statements and analyze more closely the related financial statement accounts and disclosures. We believe this is the appropriate focus of CAMs and as such, we believe that matters that are not material⁷ to a company's financial statements should not be CAMs.
- b) We share the PCAOB's view that CAMs can be differentiated from other audit matters by their relative complexity and the challenges⁸ they present to the audit.⁹ As such, we suggest retaining much of what the PCAOB proposed in paragraph 9.
- c) Given the audit committee's oversight role, we believe the auditor's determination of CAMs should consider the nature and extent of the interaction between the auditor and the audit committee. In our view, 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. As such, we believe the ultimate standard should be reflective of current 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 should be an important factor in the determination of CAMs. This approach is responsive to investor requests for further insights into auditor-audit committee communications and is consistent with the audit committee's role representing the interests of shareholders.

Finally, we believe that care should be taken to provide that auditors communicate only the most important matters, as including too many matters would minimize the intended emphasis. Accordingly, we believe that the final step in the determination of CAMs should reflect an explicit provision that if an auditor has initially identified a large number of matters for potential communication in the auditor's report, the auditor may consider reassessing whether each of these matters meets the definition of a CAM.

CAM Communication

As noted above, we do not believe that the auditor's description of the CAM needs to include each of the factors that relate to a particular matter. We believe that requiring the auditor to describe the *principal* consideration(s) that led the auditor to conclude the matter was a CAM would allow the auditor to utilize his or her professional judgment to describe the factors that were most important to the determination that a matter was a CAM and tailor such communication to provide users with useful information about the identified matters relative to the audited financial statements.

We also note that while the proposed auditor reporting standard does not require the auditor to describe the CAM's effect on the audit, each of the PCAOB's three examples of CAM reporting¹⁰ include such descriptions. We believe that in some cases describing the CAM's effect on the audit may help to explain why a matter was a CAM. While we acknowledge that the proposed auditor reporting standard does not prohibit the auditor from providing such descriptions,¹¹ we believe it would be improved by explicitly stating that the auditor may provide a description of the CAM's effect on the audit if the auditor considers it

⁷ 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 page A5-76 of the proposal.

⁸ We suggest the word "challenging" instead of "difficult" as the latter can have a more negative connotation.

⁹ See the proposal page A5-25.

¹⁰ See the proposal pages A5-65 through A5-78.

¹¹ 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."

necessary in describing why a matter is a CAM.¹² We believe such a provision would clarify the Board's intent with respect to this important area, and would provide auditors with the ability to describe the CAMs in a manner that best emphasizes why a matter is considered a CAM.

We also acknowledge the possibility that describing the CAM's effect on the audit could imply to financial statement users that the auditor is providing a separate opinion on specific accounts or balances referenced in the CAM (i.e., "piecemeal opinions") or, conversely, undermine the auditor's opinion on the financial statements taken as a whole. As such, we believe that the language preceding the communication of CAMs in the auditor's report must specify that while an audit includes the performance of procedures designed to address the risks of material misstatement associated with any identified CAMs, such procedures were designed in the context of the audit of the financial statements taken as a whole, and do not provide a separate opinion on individual accounts or disclosures. Moreover, the auditor's description of a specific CAM's effect on the audit (if included based on the auditor's judgment) should be a brief, high-level summary of the audit procedures performed to address the principal considerations that led the auditor to conclude that the matter is a CAM. We agree with the PCAOB that language that could be viewed as disclaiming or qualifying the auditor's opinion on the financial statements due to the existence of a CAM is not appropriate and must not be used. In addition, we suggest including an explicit requirement that the audit opinion must not convey that the auditor is providing a separate opinion or conclusion on the critical audit matters.

Consistent with the overarching principles articulated above, we believe that the auditor should not be the original source of information about the company. However, we acknowledge that there may be rare circumstances where, in the auditor's judgment, such information is necessary to the auditor's description of the CAM. In these situations, we believe that communication of such information would be appropriate, provided it is otherwise not prohibited by law or regulation.¹³ In such circumstances, the auditor can encourage management to make relevant disclosures, rather than the auditor being the source of such information.

CAM Documentation

While we agree that the auditor should be required to document the determination of CAMs, we do not believe the documentation requirements included in the proposed auditor reporting standard are operational. It appears that much of the documentation focus in the proposal is centered on matters the auditor ultimately concludes are not CAMs. It is often very challenging to "prove a negative" in any setting and we believe this will be particularly difficult in this area. Leveraging the suggestions noted above, we believe a more practical approach would be to require documentation of the auditor's basis for (a) identifying those matters that were communicated to the audit committee that were determined to be significant audit matters, and (b) determining which significant audit matters were CAMs. We believe this approach will help address the practical challenges associated with documenting matters that "appear to be CAMs."

II. Other Information

Overall Comments

As noted previously,¹⁴ the CAQ supports enhancements to the auditor's report that provide transparency regarding the auditor's responsibility with respect to other information. However, we believe there are several provisions within the proposed other information standard that should be modified. Our observations and suggested changes to the proposed other information standard are discussed below.

¹² This would further align the PCAOB's proposal with the IAASB's. See the IAASB's ED, Proposed ISA 701, paragraphs 10 and A38 through A41.

¹³ This improves alignment with the IAASB's ED, see Proposed ISA 701, paragraph A37.

¹⁴ See the CAQ's September 30, 2011 comment letter to the PCAOB ([link](#)).

Performance Responsibilities

The proposed other information standard expands the auditor’s performance responsibilities from “read and consider” under AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AU 550), to “read ... and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate”¹⁵ the other information for a material inconsistency, a material misstatement of fact, or both. The term “evaluate” is extensively used within the PCAOB’s auditing standards in relation to the auditor reaching an opinion (i.e., a reasonable assurance performance standard) or performing procedures to support the audit opinion.¹⁶ We believe the use of “evaluate,” in the context of the proposed other information standard, expands the auditor’s performance responsibilities. In addition, an auditor may need to perform additional procedures, outside those described within the proposed other information standard, in order to support a conclusion based on an evaluation of the other information. Additionally, the ambiguity created by the use of “evaluate” would increase the risk of undue litigation against auditors, as discussed in Appendix D.

The proposed other information standard also requires the auditor to read and evaluate other information not directly related to the financial statements. Given that the auditor may not have accumulated any information from the audit that would provide a basis for evaluating other information not directly related to the financial statements, we believe it would be inappropriate for the auditor to be required to conclude on such information.

Further, the proposed other information standard states that the auditor’s evaluation is based upon “relevant audit evidence obtained and conclusions reached during the audit.”¹⁷ This is also an expansion from AU 550 where the auditor’s responsibility relates to the financial information that is identified in the auditor’s report.¹⁸ We believe “relevant audit evidence obtained and conclusions reached during the audit” could be interpreted as requiring an extensive search for documentation within the audit workpapers to determine if the other information had been addressed in the relevant audit evidence, and may imply the inclusion of all information gathered during the audit, not just the financial information subject to audit procedures.

Reporting Responsibilities

Requiring the auditor to communicate in the auditor’s report that the auditor has evaluated the other information and conclude whether the auditor has identified a material inconsistency, a material misstatement of fact, or both, would imply a level of assurance that is inconsistent with the proposed procedures. This may cause users of the financial statements to perceive the auditor’s “conclusion” on the entirety of other information as a form of reasonable assurance on such information, despite the auditor making an explicit statement in the auditor’s report that he or she did not audit the other information and does not express an opinion on the other information. We believe this will lead to a widening of the expectation gap. Further, requiring the auditor to state whether he or she has identified a material inconsistency, a material misstatement of fact, or both, would create significant incremental litigation risk for auditors, as discussed in Appendix D. Our suggested changes discussed below include reporting of the auditor’s responsibilities with respect to other information and procedures performed and, where applicable, describing any unresolved material inconsistencies or material misstatements of fact. This approach makes more explicit an auditor’s present responsibilities and we believe it will help address certain legal risks inherent in the proposed other information standard.

¹⁵ See the proposed other information standard paragraph 4.

¹⁶ For example, paragraph 6 of PCAOB Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (pending final SEC approval), “To form an opinion on the supplemental information, the auditor should evaluate...”; paragraph 9 of PCAOB Auditing Standard No. 7, *Engagement Quality Review*, “the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report”; and paragraph 8 of PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, “In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.”

¹⁷ See the proposed other information standard paragraph 4.

¹⁸ AU 550, paragraph 4.

Suggested Changes to the Auditor’s Performance Responsibilities

As described below, we have developed suggested changes that we believe will help achieve the Board’s objectives, while addressing the considerations described above. In articulating our suggested changes, we recognize the fundamental difference between other information that is directly, and not directly, related to the audited financial statements and the need for different procedures for each of these types of other information. Appendix B reflects our suggested changes to the Objectives and Auditor’s Responsibilities sections of the proposed other information standard.

“Evaluate” Other Information

To more clearly define the auditor’s performance responsibilities regarding other information, we suggest replacing “evaluate” with “perform certain limited procedures,” and that the expected limited procedures be identified in the standard. These limited procedures (which include reading the other information) provide a “plain English” description of the performance expectations that more closely align the performance requirements with the extant standard and, as a result, will be more operational in practice and better understood by users. Further, to focus the auditor’s performance responsibilities regarding financial statement-related information, we believe the limited procedures that extend beyond reading should only apply to other information directly related to the audited financial statements. In the context of our suggested changes, we are using a definition for other information directly related to the audited financial statements that focuses on other information derived either (1) from the financial statements or (2) from accounting records subject to the audit. We encourage the Board to consider incorporating the suggested definition within the standard.

Additionally, in identifying other information that falls within the scope of the auditor’s performance responsibilities, it is critical to include the consideration of materiality. Therefore, we recommend that any procedures, beyond reading the other information, apply only to *material* other information that is directly related to the audited financial statements.

Relevant Audit Evidence and Conclusions Reached During the Audit

We believe the auditor’s performance responsibilities regarding material other information directly related to the audited financial statements should be related to (1) the financial statements or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation. We believe this could also limit the auditor from having to perform extensive searches within the audit workpapers to determine if other information had been addressed in the audit.

Certain Limited Procedures

Based on our suggestions above, we have recommended modifications to the proposed other information standard to describe the certain limited procedures the auditor would perform. These limited procedures include reading all of the other information, and for material other information directly related to the audited financial statements, performing the following:

- a) Comparing the amounts in the other information, and the consistency of the manner of their presentation, that are the same as, or provide greater detail about, the amounts in the financial statements, to (1) the amounts in the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation;
- b) Comparing qualitative statements that represent, or provide greater detail about, information in the financial statements, to (1) the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation; and
- c) Recalculating the mathematical accuracy of the amounts in the other information that are calculated using amounts in (1) the other information, (2) the financial statements, or (3) accounting records that

are subject to the audit, or have been derived directly from such accounting records by analysis or computation.

Other Information Not Directly Related to the Financial Statements

We believe the auditor's performance responsibilities for other information not directly related to the audited financial statements should be consistent with AU 550, which requires the auditor to read the other information and, if the auditor becomes aware of a potential material misstatement of fact in the other information, to respond appropriately.¹⁹ Further, we believe the auditor's identification of potential material misstatements of fact should be based on knowledge gained in the course of conducting the audit, in order to link the auditor's performance responsibilities to the audited financial statements. Finally, since the auditor performs different procedures depending on whether the other information is directly, or not directly, related to the financial statements, we have separated these procedures within our suggested approach.

Suggested Changes to the Auditor's Reporting Responsibilities

As noted above, we support changes to the auditor's report that provide transparency about the auditor's responsibility with respect to other information. Specifically, we believe the auditor's reporting should describe the auditor's responsibilities to perform certain limited procedures on the other information, and emphasize that these limited procedures do not constitute an audit or review of the other information. The auditor's report should also include:

- a) 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, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement, or both, in the auditor's report; and
- b) 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, a description of the material inconsistency, the material misstatement of fact, or both.

We believe that this reporting would clearly communicate the auditor's responsibilities regarding other information, and whether the auditor was aware of an unresolved material inconsistency with the audited financial statements or a material misstatement of fact in the other information, while helping to mitigate certain of the litigation risks discussed in Appendix D. This reporting is illustrated in the context of an unqualified auditor's report in Appendix C, and is addressed by paragraphs 13 and 14 in Appendix B.

Other Information Documentation Requirements

The proposed other information standard does not provide guidance regarding the nature and extent of documentation that would be required with respect to the fulfillment of the auditor's performance responsibilities. The expansion to a "read and evaluate" performance responsibility could expand the auditor's efforts to document the procedures performed, including documenting the source of each qualitative or quantitative statement or number (irrespective of whether it relates to the financial statements). Our recommendations above will assist in focusing the auditor's documentation efforts, by more clearly articulating the auditor's performance requirements, outside reading the other information, to material other information directly related to the audited financial statements. However, to promote consistency in practice, we recommend that the PCAOB provide guidance within the other information standard on how the auditor should document the procedures performed addressing other information.

¹⁹ AU 550, paragraph 5.

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 to²⁰ – and information incorporated by reference in – the annual report.²¹ We believe auditors would benefit from clarification regarding what exhibits would fall within the scope of the auditor's performance responsibilities. For instance, certain exhibits (e.g., plan(s) of acquisition or material contracts) may have been subject to audit procedures due to their relevance to the audit of the financial statements, and it may not be appropriate to subject these exhibits to the procedures within the proposed other information standard.

Further, the proposed other information standard would require the auditor to evaluate other information included in the proxy statement, which may not be filed until 120 days after year end.²² It is unclear how this requirement can be applied in practice, as this information may not be prepared or available until after the respective Form 10-K is filed, and we do not believe it would be appropriate for the auditor to conclude in the auditor's report on information that is not available at the time the auditor's report is issued. Further, it is unclear from the proposed other information standard what impact the auditor's responsibility to perform certain procedures on this other information would have on the previously filed auditor's report. For example, when the proxy statement is filed subsequent to the Form 10-K, is the auditor required to provide a dual-dated audit opinion to reflect the performance of the required procedures on the other information in the proxy statement, subsequent to the issuance of the initial auditor's report?

We believe that describing the auditor's performance responsibilities in the auditor's report, rather than stating a conclusion, will help mitigate some of the scope matters discussed above. However, if the Board does not agree with the suggested changes, and requires a conclusion in the auditor's report, we believe the final other information standard should either exclude documents that do not exist at the date of the auditor's report (including the proxy statement) or clarify the auditor's reporting responsibilities for this information, including the impact on the previously issued auditor's report.

III. Auditor Tenure

As noted in the proposal, the PCAOB has not found a correlation between audit quality and auditor tenure.²³ We believe that including auditor tenure in the auditor's report would create the false impression that such a correlation exists and would give undue prominence to this information. Accordingly, we do not believe that auditor tenure should be included in the auditor's report.

However, we do support other ways of making auditor tenure more transparent. For example, as noted in a recent study, a growing number of audit committees of Fortune 100 companies have decided to disclose the tenure of their auditors.²⁴ The CAQ, in collaboration with several governance organizations, encouraged all audit committees to consider such disclosures in a recent "Call to Action."²⁵

Additionally, the PCAOB could require auditors to provide this information on the PCAOB's Form 2,²⁶ which would be a more appropriate place for this disclosure than the auditor's report given the lack of nexus between auditor tenure and audit quality.

²⁰ See the proposal, footnote 15, appendix 6.

²¹ See the proposed other information standard, "Note" in paragraph 1.

²² *Ibid.*

²³ See the proposal page A5-16.

²⁴ *Audit Committee Reporting to Shareholders, 2013 Proxy Season*, EY ([link](#)).

²⁵ *Enhancing the Audit Committee Report: A Call to Action*, released by the "Audit Committee Collaboration" consisting of the following organizations: National Association of Corporate Directors; NYSE Governance Services, Corporate Board Member; Tapestry Networks; The Directors' Council; the Association of Audit Committee Members, Inc.; and the CAQ ([link](#)).

²⁶ Additional information regarding the PCAOB's rules and requirements for periodic filings by registered public accounting firms, including Form 2, can be found here ([link](#)).

IV. Auditor’s Unqualified Report and Clarifying Language Changes

The CAQ joins the Board in recognizing the value of the “pass/fail” opinion in the auditor’s report. We also believe that standardized language in the auditor’s report represents a significant benefit to financial statement users as it serves to narrow the expectation gap through an enhanced understanding of the auditor’s role and responsibilities, the audit process, and responsibilities of others in the financial reporting supply chain. Standardized language also promotes consistency in practice across auditors’ reports, because it serves to mitigate potential financial statement user misunderstanding that could occur through the use of inconsistent language.

Basic Elements

We appreciate the Board’s consideration of input received on the Concept Release related to clarifying language and we support proposed changes to enhance the wording of the auditor’s report in relation to independence and the auditor’s responsibilities regarding the notes to the financial statements and material misstatement, whether due to error or fraud. We also support proposed changes to better align the description of the nature of an audit with the Board’s risk assessment standards.

We agree with the Board’s decision not to require that the basic elements appear in a specific order in the auditor’s report, other than the requirement that CAMs follow the opinion and any explanatory paragraphs. We do, however, recommend requiring the use of consistent paragraph captions regarding the basic elements of the auditor’s report (e.g., the introduction, the basis of opinion, and the opinion on the financial statements), as such captions will assist financial statement users in better understanding the auditor’s report.

We do not, however, support addressing the auditor’s report to parties other than shareholders and the board of directors (or an equivalent body). As noted in Appendix D, we believe this would create additional litigation risk and would not improve the communicative value of the auditor’s report.

Addition of Clarifying Language to the Standard Auditor’s Report

The CAQ suggests that the PCAOB consider incorporating into its final auditor reporting standard five elements of clarifying language that are generally consistent with the IAASB’s exposure draft²⁷ and with suggestions we provided in our 2011 letters to the PCAOB.²⁸ We continue to believe that these changes would enhance users’ understanding of the auditor’s role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain, and would promote consistency of auditor reporting globally. These additional elements take on added importance in the context of the contemplated changes to the auditor’s report related to CAMs and other information.

1. *Management and Audit Committee Responsibilities* - Provide an expanded discussion covering management and the audit committee’s responsibilities for the financial statements.
2. *Auditor’s Responsibility for the Financial Statements* - Explicitly identify that the auditor is responsible for expressing an opinion on the financial statements “taken as a whole” when referring to those financial statements throughout the auditor’s report.
3. *Reasonable Assurance* - Describe what is meant by the term “reasonable assurance.”
4. *Professional Judgment and Professional Skepticism* - Highlight the necessity of using professional judgment in assessing audit risk, selecting audit procedures, and considering the issuer’s internal control over financial reporting when responding to such risks. State that the auditor is responsible for maintaining professional skepticism throughout the planning and performance of the audit.
5. *Audit Evidence* - Refer to “the procedures performed and the audit evidence obtained” as providing the reasonable basis for an audit opinion.

²⁷ See IAASB ED, illustrative auditor’s report on pages 13 through 16.

²⁸ See CAQ comment letters to the PCAOB dated September 30, 2011 ([link](#)) and June 28, 2011 ([link](#)).

Appendix C illustrates these proposed changes in the context of an auditor's unqualified report.

V. Applicability

Critical Audit Matters

We believe that auditors of brokers and dealers, investments companies, and employee benefit plans (i.e., employee stock purchase, savings, and similar plans) should not be subject to the identification, communication, and documentation of critical audit matters under the proposed auditor reporting standard. Benefit plans and registered investment companies are typically designed for a specified purpose and, as a result, would likely have similar critical audit matters. For example, CAMs for these entities would likely include auditing hard-to-value investments. There are already extensive disclosure requirements regarding the fair value of investments pursuant to Accounting Standards Codification 820, *Fair Value Measurement*. We believe that financial statement users understand that financial instrument fair value issues are important to both the preparation and audit of such financial statements. We question whether the inclusion of CAMs in the audit reports for these entities would add much value.

In addition, as noted in the PCAOB Release, the ownership of brokers and dealers is primarily closely held (per the PCAOB's Office of Research and Analysis, approximately 75% of the brokers and dealers have five or fewer direct owners), and the direct owners are generally part of the entity's management. Accordingly, we believe that requiring the auditors of these entities to communicate critical audit matters would not provide investors or other financial statements users with additional relevant information to justify the incremental cost.

Other Information

In our view, 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-5²⁹ 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*³⁰ 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.

Employee benefit plans that file a Form 11-K with the SEC are also required to file their financial statements and auditor's report with the U.S. Department of Labor, which requires an audit conducted in accordance with U.S. generally accepted auditing standards. Requiring employee benefit plan audits to be subject to the scope of the proposed other information standard could create the potential for two very different auditor's reports to be issued for the same plan. Moreover, employee benefit plans that file a Form 11-K contain a limited amount of other information, which is not the predominant source of information used by plan participants to make investment decisions.

Emerging Growth Companies

We believe that both the proposed auditor reporting standard and the proposed other information standard should be applicable to emerging growth companies (EGCs). As we have noted previously,³¹ certain financial reporting risks can be more prevalent with EGCs than other public companies because of the size, nature, and complexity of their business model, capital structure, business processes and controls, and regulatory environment.

²⁹ SEC Release No. 34-70073, Final Rule, Broker-Dealer Reports ([link](#)).

³⁰ PCAOB Release 2013-007 ([link](#)).

³¹ See the CAQ's "Related Parties" comment letter dated July 3, 2013 ([link](#)).

VI. Cost-Benefit Considerations

While there are clear benefits to the Board’s proposal, there will be added costs and implementation challenges associated with a project of this magnitude. We have offered suggested changes to the proposal that we believe will retain or increase the benefits expected to be realized by the proposal, while helping to reduce the associated costs.

Critical Audit Matters

Our approach streamlines the auditor’s process for determining CAMs and related documentation requirements by leveraging the auditor’s required communications with the audit committee under AS 16. A key benefit of our approach is that it is designed around how audits are currently conducted, how matters are communicated to the audit committee, and how matters are documented in the audit workpapers, which will reduce the incremental effort and costs associated with application of the final auditor reporting standard.

As anticipated by the Board,³² we believe that auditor reporting of CAMs will result in additional effort by the auditor, as well as by those who prepare and review a company’s financial statements (e.g., management and the audit committee). Much of this work will occur at the end of the audit, when remaining issues are being resolved and final reviews are occurring. We anticipate that our field-testing effort will provide some insights into what effect this might have on the audit, but we also encourage the Board to conduct a robust analysis of the costs and benefits of the proposed auditor reporting standard that addresses the potential effect on key stakeholders including companies, audit committees, and investors.

Other Information

As discussed above, the proposed other information standard requires the auditor to evaluate other information based on relevant audit evidence obtained and conclusions reached during the audit. The proposed other information standard does not differentiate between information that is directly related to the financial statements and information that is not. Without making these distinctions, we believe the proposed other information standard would result in significant incremental effort and cost, particularly as it relates to non-financial information, which would far exceed the benefits. We believe our recommendations build upon the benefits that exist today with a lower impact on costs.

The proposed other information standard would require an auditor to conclude in each auditor’s report whether the auditor identified a material inconsistency or a material misstatement of fact in the other information.³³ We believe that auditor reporting solely with respect to unresolved material inconsistencies with the financial statements or material misstatements of fact in the other information, coupled with a clear description of the auditor’s responsibilities related to other information, will achieve the desired transparency without an unnecessary increase in litigation risks.

We believe it will be essential for investors and other financial statement users to have an understanding of the effect the proposed other information standard will have on the auditor’s current responsibilities related to other information, audit costs, and the company’s financial reporting process. Our field-testing effort is expected to help inform this discussion, but we encourage the PCAOB to carefully consider these factors in its analysis of the costs and benefits of the proposed other information standard.

Legal Considerations

The proposal requests comments on the liability risks associated with the proposal, noting in respect of both CAMs and other information that “the auditor would be making new statements in the auditor’s report” which

³² See the proposal page 17.

³³ See the proposed other information standard paragraph 14.

could raise potential liability concerns or considerations.³⁴ The risk of increased liability that accompanies the form of report contemplated by the proposal is real and substantial, as described further in Appendix D. We believe that our proposed changes to the PCAOB's approach would help to mitigate the potentially significant additional liability exposure inherent in the proposal, while at the same time providing more information to financial statement users and resulting in auditing standards that can be applied consistently.

We fully support the Board's efforts to enhance the information communicated by the auditor in the auditor's report and we embrace calls for change. We appreciate the opportunity to comment on the proposal and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

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
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Brian T. Croteau, Deputy Chief Accountant
Julie Erhardt, Deputy Chief Accountant
Daniel Murdock, Deputy Chief Accountant

IAASB

Prof. Arnold Schilder, Chair
James Gunn, Technical Director

³⁴ See the proposal pages A5-44 and A6-40.

Appendix A – Illustration of Suggested Changes to the Proposed Auditor Reporting Standard and Examples

Note: This appendix reflects our suggested changes to paragraphs 7 through 14 of the proposed auditor reporting standard, and example CAM reporting to illustrate these changes.

Critical Audit Matters

Determination of Critical Audit Matters

7. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements based on the results of the audit or evidence obtained.

Note: It is expected that in most audits, the auditor would determine that there are critical audit matters.

8. As a first step in the determination of critical audit matters (see paragraph 9), the auditor identifies matters that are significant to the audit of the financial statements, and communicated to the audit committee pursuant to Auditing Standard No. 16 ("significant audit matters"). In identifying significant audit matters, the auditor should take into account the following general factors, as well as other factors specific to the audit:

- a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
- b. The nature and extent of audit effort required to address the matter;
- c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;
- d. The severity of control deficiencies identified relevant to the matter, if any;³⁵
- e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;
- f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;
- g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and
- h. The nature of consultations outside the engagement team regarding the matter, if any.

9. Critical audit matters are those significant audit matters that, in the auditor's judgment, a) were material to the financial statements, b) 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, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee.

In general, the greater the number of matters thought to represent critical audit matters, the less useful the auditor's communication of such matters may be. If an auditor has initially identified a large number of matters for potential communication in the auditor's report, the auditor may consider reassessing whether each of these matters meets the definition of a critical audit matter.

³⁵ Other PCAOB standards provide auditing and reporting requirements related to the company's internal control over financial reporting. See Auditing Standard No. 5, Auditing Standard No. 12, and AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements*.

Communication of Critical Audit Matters

10. The auditor must communicate in the auditor’s report critical audit matters relating to the audit of the current period’s financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period’s financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor’s report on the prior period’s financial statements because the previously issued auditor’s report could no longer be relied upon.

11. For each critical audit matter to be communicated in the auditor’s report, the auditor must:

- a. Identify the critical audit matter;
- b. Describe the principal consideration(s) that led the auditor to conclude that the matter was a critical audit matter and, if the auditor considers it necessary as part of the explanation, include a brief description of its effect on the audit; and
- c. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Each description should be succinct, objective, and fact-based. Language that could be viewed as disclaiming or qualifying the auditor’s opinion on the financial statements due to the existence of a critical audit matter is not appropriate and must not be used. Additionally, the audit opinion must not convey that the auditor is providing a separate opinion or conclusion on critical audit matters.

In describing the principal consideration(s) that led the auditor to conclude that the matter was a critical audit matter, the auditor should avoid providing information about the company’s financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company’s management to consider for disclosure unless, in the auditor’s judgment, such information is necessary to the auditor’s description and providing such information is not prohibited by law or regulation. In such circumstances, the auditor can encourage management to make relevant disclosures rather than the auditor being the source of such information.

Language Preceding Critical Audit Matters in the Auditor’s Report

12. The following language, including the section title “Critical Audit Matters,” should precede critical audit matters communicated in the auditor’s report:

Critical Audit Matters

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 a separate opinion 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.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

13. In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title “Critical Audit Matters,” in the auditor’s report:

Critical Audit Matters

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. We determined that there are no critical audit matters. Other matters, that we determined were not critical audit matters, were discussed with the audit committee during the course of our audit.

Documentation of Critical Audit Matters

14. In accordance with Auditing Standard No. 3, the auditor must document the determination of critical audit matters. Auditing Standard No. 3 requires audit documentation to be prepared in such detail to provide a clear understanding of its purpose, source, and the conclusions reached. To provide sufficient detail for a clear understanding of the conclusions reached regarding the determination of critical audit matters, the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor’s:

- a. Identification of matters communicated to the audit committee that were significant audit matters; and
- b. Determination of which significant audit matters were critical audit matters.

Illustrative Examples of CAM Reporting

The revised CAM examples below are based on the same facts provided by the PCAOB on pages A5-65 through A5-78 of the proposal. The reporting in these revised examples is consistent with the approach suggested above. In this regard, we believe the suggested communication is fulsome and informative. The circumstances in each example may not lend themselves to an auditor determining to provide a further description of the CAM’s effect on the audit. However, we offer, in the bracketed text, what such further disclosure might look like. Such illustrations may be helpful in developing language for situations where an auditor’s discussion of a CAM’s effect on the audit might, in the auditor’s judgment, be more relevant. As we review the results of the field-testing effort, we will consider developing one or more additional example CAMs to better illustrate when the auditor might describe the CAM’s effect on the audit in accordance with paragraph 11(b) above.

As required by paragraph 12 above, the text directly below would precede the critical audit matters communicated in the auditor's report:

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 a separate opinion 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.

Example 1 — Allowance for Sales Returns

The Company developed a new on-line sales channel, which could have a significantly different return experience than sales through its more established retail stores. In addition, the Company simultaneously lengthened its return policy and developed new models with different assumptions to reflect these changes in its estimate of the allowance for sales returns, which is a key element in determining revenue.

We determined that our evaluation of the Company's allowance for sales returns was a critical audit matter in the audit of the Company's financial statements as of and for the fiscal year ended January 31, 2013. This was due to the changes in the Company's distribution channel and sales return policy and the Company's lack of historical experience with the new on-line sales channel, which resulted in a high degree of measurement uncertainty in estimating the allowance for sales returns. The Company's accounting policy for sales returns is discussed in Note 1 to the financial statements.

[Our audit involved challenging and subjective judgments in evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns. We designed and performed procedures to test management's assumptions and the data underlying the Company's estimate of future sales returns related to the new on-line sales channel. Our procedures included, among others, assessing the reasonableness of management's judgments regarding the effect of changes in the Company's return policies and practices, as well as the changes in economic and buying trends that affect customer behavior.]

Example 2 — Valuation Allowance for Deferred Tax Assets

The Company recorded a deferred tax asset balance of \$XXX million related to federal net operating loss carryforwards, as of June 30, 2013. In recognizing its deferred tax asset balance, the Company concluded that no valuation allowance was required. The Company exercised significant judgment in evaluating the realizability of its deferred tax assets, which included consideration of the losses in recent periods and an unexpected cost increase in a critical product component in 2013. The Company's analysis also considered other evidence, such as the expected timing of reversals of existing temporary differences, forecasts of future taxable income, and tax planning strategies.

We determined that our assessment of the Company's evaluation of the realizability of its deferred tax asset balance was a critical audit matter in the audit of the Company's financial statements as of and for the year ended June 30, 2013. This was due to the complexity and subjectivity involved in management's judgments regarding the reasonableness of the weight given to the positive and negative evidence, including the data underlying management's forecasts of its future taxable income. The Company's accounting policy and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12 to the financial

statements.

[Our audit involved challenging management's estimate of the realizability of its deferred tax assets, including procedures to evaluate the reasonableness of the Company's forecasts of future taxable income. This included evaluating the sensitivity of the Company's forecasts based on the general economic environment, the Company's industry and competitive conditions, and the length of time associated with the Company's forecasts. This also included an evaluation of the timing and potential impact of product enhancements and new product introductions, the effect of eliminating certain product lines, and the expectation regarding the level of product recall and relocation costs.]

Example 3 — Fair Value of Fixed Maturity Securities Held as Investments That are Not Actively Traded

Approximately 35% of the Company's investment portfolio is comprised of private label mortgage-backed securities and collateralized loan obligations. The process to determine the fair value of these investments primarily utilizes in-house valuation models, discounted cash flow methodologies, or other techniques that utilize inputs that cannot be derived from, or corroborated by, currently observable data, including credit spreads that reflect specific credit-related issues.

We determined that the valuation of the Company's private label mortgage-backed securities and collateralized loan obligations was a critical audit matter in the audit of the Company's financial statements as of and for the year ended December 31, 2012. This was because of the high degree of estimation uncertainty due to the lack of observable inputs used in determining the fair value of these investments. The Company's disclosures related to the nature and fair value of these securities and the methods the Company used to determine those fair values are in Note 6 to the financial statements.

[Our audit involved evaluating the reasonableness of the Company's valuation methodologies and whether they were consistently applied. We performed tests of the Company's fair value determination by (a) testing management's significant assumptions, the Company's valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, and (c) considering subsequent events and transactions.]

Appendix B – Illustration of Suggested Changes to the Proposed Other Information Standard

Note: This appendix reflects our suggested changes to the Objectives, Auditor’s Responsibilities, and Reporting in the Auditor’s Report sections of the proposed other information standard.

Objectives

2. The objectives of the auditor are:

- a. To perform certain limited procedures on other information, and determine whether he or she is aware of (1) a material inconsistency between amounts or information, or the manner of their presentation, and the audited financial statements (“material inconsistency with the audited financial statements”); (2) a material misstatement of fact in the other information; or (3) both, and if so, to respond appropriately; and
- b. When issuing an auditor’s report, to communicate in the auditor’s report:
 - i. The auditor’s responsibilities to perform certain limited procedures on other information;
 - ii. 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, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement in the auditor’s report; and
 - iii. That the auditor has not audited or reviewed the other information.

Auditor’s Responsibilities

3. The auditor should read the other information, and with respect to material other information directly related to the audited financial statements, perform the following additional procedures:

- a. Compare the amounts in the other information, and the consistency of the manner of their presentation, that are the same as, or provide greater detail about, the amounts in the financial statements, to (1) the amounts in the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation;
- b. Compare qualitative statements that represent, or provide greater detail about, information in the financial statements (e.g., critical accounting estimates, or the description of off-balance sheet arrangements), to (1) the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation;
- c. Recalculate the mathematical accuracy of the amounts in the other information that are calculated using amounts in (1) the other information, (2) the financial statements, or (3) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation.

Note: For example, the auditor would recalculate the amounts when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula. Amounts, such as totals or percentages, that are calculated using simple mathematical operations, such as addition or division, ordinarily can be recalculated without referring to a formula. If the auditor needs to refer to a formula for the recalculation of an amount, such as for return on capital employed, the auditor would be required to recalculate the amount only when the formula is provided, or described in the annual report. However, the auditor would not be required to evaluate the appropriateness or sufficiency of the formula used in the calculation.

4. In reading other information not directly related to the audited financial statements, if, based on knowledge gained in the course of conducting the audit, the auditor becomes aware of a potential material misstatement of fact in the other information, the auditor should perform the procedures in paragraph 5.³⁶

5. If, based on the procedures performed in paragraphs 3 and 4, the auditor becomes aware of a potential material inconsistency with the audited financial statements, a potential material misstatement of fact in the other information, or both, the auditor should discuss the matter with management. The auditor also should perform additional procedures, as necessary, to determine whether there is a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both.

Reporting in the Auditor's Report

13. When issuing an auditor's report, the auditor must include, in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information," the following:

- a. A statement that, in order to issue an audit report under the standards of the Public Company Accounting Oversight Board ("PCAOB"), the auditor is required to perform certain limited procedures on other information and determine whether he or she is 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;
- b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;
- c. A statement that the limited procedures included reading the other information, and with respect to material other information directly related to the audited financial statements, comparing the other information to (1) the financial statements or (2) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information;
- d. A statement that these limited procedures do not constitute an audit or review of the other information;
- e. 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, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement, or both, in the auditor's report; and
- f. 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, the auditor should provide a description of the material inconsistency, the material misstatement of fact, or both.

14. The following is an example of "The Auditor's Responsibilities Regarding Other Information" section of the auditor's report:

- a. Illustrative language for paragraphs 13.a.– e.:

The Auditor's Responsibilities Regarding Other Information

In order to issue an audit report on the Company's financial statements, in accordance with the standards of the PCAOB, we are required to perform certain limited procedures on other information, included in the annual report on [SEC Exchange Act form type] filed with the SEC that contains both the [period end date] financial statements and our audit report on those financial statements, and determine whether we are aware of a material inconsistency

³⁶ This represents paragraph 4(c) of the proposed other information standard, incorporated into a separate paragraph.

with the audited financial statements, a material misstatement of fact in the other information, or both. These limited procedures do not constitute an audit or review of the other information. Such procedures include reading the other information and, with respect to the material other information directly related to the audited financial statements, comparing it to (a) the financial statements or (b) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information. In the event we become 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, or both, that has not been appropriately revised, we are required to describe the inconsistency, misstatement, or both, in our audit report.

- b. Illustrative language for paragraph 13.f. when 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:

Based on performing certain limited procedures, we became 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. [Describe the material inconsistency with the audited financial statements, the material misstatement of fact in the other information, or both.]



Appendix C – Illustration of an Unqualified Auditor’s Report

Note: This appendix illustrates our suggested changes to the Illustrative Auditor’s Unqualified Report on pages A1-15 and A1-16 of the proposed auditor reporting standard. Suggested additions are underlined; suggested deletions are struck through.

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

Introduction

We have audited the accompanying balance sheets of X Company (the “Company”) as of December 31, 20X2 and 20X1, the related statements of operations, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 20X2, and the related notes (collectively referred to as the “financial statements”). ~~These financial statements are the responsibility of the Company’s management.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board (“PCAOB”) (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission (“SEC”) and the PCAOB. ~~We or our predecessor firms have served as the Company’s auditor since [year].~~

Management and Audit Committee Responsibilities for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [applicable financial reporting framework], and for establishing and maintaining adequate internal control over financial reporting to enable the preparation of financial statements that are free of material misstatement, whether due to error or fraud.

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

Basis of Opinion

Our responsibility is to express an opinion on the Company’s financial statements, taken as a whole, based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit conducted in accordance with PCAOB standards may not always detect a material misstatement.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. In the course of completing our audits, the audit evidence we obtain is often

persuasive rather than conclusive. The procedures selected for performance depend on our judgment, including our assessment of the risks of material misstatement of the financial statements, whether due to error or fraud. In making those risk assessments, we consider internal controls relevant to the Company's preparation and fair presentation of the financial statements in conformity with [applicable financial reporting framework] in order to design audit procedures that we believe are appropriate in the circumstances. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We maintain professional skepticism throughout the planning and performance of the audit. We believe that the procedures performed and the audit evidence obtained provide our audits provide a reasonable basis for our opinion.

Opinion on the Financial Statements

In our opinion, the financial statements, taken as a whole, referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [applicable financial reporting framework].

Critical Audit Matters

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 ~~those matters addressed during the audit that, in our judgment,~~ a) were material to the financial statements, (1)b) involved our most difficult challenging, subjective, or complex judgments, (2) posed the most difficulty greatest challenge to us in obtaining sufficient appropriate evidence, (3) posed the most difficulty greatest challenge to us in forming our an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole. 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 a separate opinion 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.

[Include critical audit matters]

The Auditor's Responsibilities Regarding Other Information

In order to issue an audit report on the Company's financial statements in accordance with the standards of the PCAOB, we ~~evaluated whether the~~ are required to perform certain limited procedures on other information, included in the annual report on [SEC Exchange Act form type] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, contains a and determine whether we are aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information. These limited procedures do not constitute an audit or review of the other information. Such procedures include reading the other information and, with respect to the material other information directly related to the audited financial statements, comparing it to (a) the financial statements or (b) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation,

and, where applicable, recalculating the mathematical accuracy of the other information. In the event we become 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, or both, that has not been appropriately revised, we are required to describe the inconsistency, misstatement, or both, in our audit report.

[Signature]

[City and State or Country]

[Date]

Appendix D – Legal Considerations

Note: This appendix presents our response to the questions in the proposal regarding the liability risks associated with the proposed standards.

The proposal notes in respect of both CAMs and other information that “the auditor would be making new statements in the auditor’s report” which could raise potential liability concerns or considerations.³⁷ The risk of increased liability that accompanies the form of report contemplated by the proposal is real and substantial. As discussed below, any expansion of the auditor’s report is almost certain to lead to additional liability exposure for the independent auditor. The proposal creates more statements that would be directly attributable to the auditor and which a financial statement user – for example, a shareholder that suffers a loss following a decline in an issuer’s stock price – could claim were materially misleading or omitted required information. Accordingly, these changes are likely to lead to an increase in the number of cases being filed against issuers and their auditors generally, and an increase in the number of claims that may be asserted in any individual case.

Although it is not possible to quantify the magnitude of the incremental risk, we do believe it will be significant. We believe that our suggested changes would help to mitigate (at least, to some extent) the potentially significant additional liability exposure inherent in the PCAOB’s proposal, while at the same time providing more information to financial statement users and resulting in auditing standards that can be applied consistently.

Critical Audit Matters

A requirement to identify and report on CAMs would increase an auditor’s liability risk under both federal and state law. A user that suffers a loss in connection with his or her investment in an issuer’s securities may claim that the auditor should bear some responsibility because the investor relied on statements made by the auditor about CAMs. Such a claim would most likely suggest that the auditor either (i) materially misstated a CAM or (ii) failed to include a CAM in the auditor’s report. There is a risk that whatever the auditor says will be challenged after the fact – as communicating too little, or too much, or characterizing the information in the wrong way.

The liability risk presented by including a description of CAMs in the auditor’s report is exacerbated by the scope of matters that would be considered in the auditor’s determination of CAMs. The factors that may make an audit matter “critical” are broadly defined, and many judgments made during the course of an audit would touch on one or more of those factors. This lack of clarity will add further uncertainty to how a lawsuit will unfold, which will increase litigation costs by making early resolution difficult. The proposed requirement that auditors document matters that appear to be CAMs but are not, further adds to those risks. Our suggested changes to the proposed auditor reporting standard attempt to mitigate these risks by providing greater clarity regarding the auditor’s process for determining CAMs.

This risk increases to the extent the proposed auditor reporting standard introduces novel concepts to the regulatory landscape. The concept of materiality currently underlies the liability regime under the federal securities laws, and is defined in respect of the “total mix” of information available to investors. The proposed auditor reporting standard introduces an additional concept: matters that were critical to the audit, but which (as is clear from the examples set out in the proposal) may not be “material” as that term is applied under the securities laws.³⁸ The changes we suggest attempt to mitigate this risk by incorporating the concept

³⁷ See the proposal pages A5-44 and A6-40.

³⁸ By way of example, the auditor in example 3 identifies a control deficiency, but not one significant enough to be a material weakness, or presumably require an adverse opinion under PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, so it does not separately require disclosure.

of materiality in the determination of CAMs, thereby aligning the auditor’s reporting model with existing concepts governing liability under the federal securities laws.

Different risks are created by the fact that someone, after the fact, can claim that there was a material misstatement or omission with respect to an item which was identified as a CAM. An investor might allege that the auditor should have said more in its reporting of CAMs, claiming that some detail known to the auditor should have been communicated, or that it was not communicated with sufficient clarity. On the other hand, the company might object that these additional details disclose a client confidence or competitive information, or might raise confidentiality concerns under other regulatory regimes (e.g., bank regulatory requirements). By requiring the auditor to describe the *principal* consideration(s) that led the auditor to conclude that a matter was a CAM, and aligning the auditor’s statements about a CAM with the existing rules governing corporate disclosure, our suggested changes to the proposed auditor reporting standard help mitigate the possibility that such situations will arise.

Although we support an express provision allowing the auditor to explain the CAM’s effect on the audit, if the auditor considers it necessary, we should note that this by itself could expand liability risk. Plaintiffs in federal securities fraud lawsuits are required to plead fraud “with particularity” when bringing claims under Rule 10b-5, and an inability to do so requires the dismissal of the lawsuit at the outset. A description of audit steps taken by the auditor can enable plaintiffs to support meritless claims by including these details in their pleadings, which could cause courts to hesitate in dismissing such claims. Our suggested approach helps limit this risk, but does not eliminate it. For example, where the auditor does not describe audit procedures related to the CAM(s), plaintiffs may allege instead that the description of the CAM should have been more fulsome.

Other Information

Two aspects of the proposed other information standard are likely to significantly increase the risk of litigation for auditors. The first aspect is the proposed wording of the new performance responsibilities. The proposed other information standard would change the “read and consider” requirement under paragraph 4 of AU 550 to a “read and evaluate” requirement, which we believe could be read to impose a substantially greater set of obligations on the auditor. Indeed, the proposal states that the Board opted for the phrase “should evaluate” because, unlike “should consider,” it requires the auditor to “*come to a conclusion* based on the performance of certain procedures (emphasis added).”³⁹ On this basis, plaintiffs will likely allege that the word “evaluate” makes the auditor responsible for what is and is not said by the issuer in MD&A and elsewhere. We are particularly concerned that this increased obligation makes the auditor responsible not only for what the issuer discloses but also for omissions.

The second aspect is the requirement that the auditor state in the auditor’s report that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information, when such is the case. This affirmative statement reads as if it is an opinion or conclusion that the other information is not misleading – even though under the proposed other information standard the auditor would also state that it is not, in fact, expressing an opinion.

The U.S. Supreme Court has issued several opinions addressing Rule 10b-5 secondary liability (which in the past was often applied to auditors). Beginning with *Central Bank*⁴⁰ in 1994 and extending more recently to *Janus Capital Group v. First Derivative Traders*,⁴¹ the Court has made clear that persons cannot be held liable under Section 10(b) and Rule 10b-5 unless they actually “make” a statement. These decisions make clear that while an auditor may be liable for misstatements in its audit reports on financial statements or internal control, its liability is confined to such reports and cannot be extended to other documents or

³⁹ See the proposal page A6-15.

⁴⁰ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

⁴¹ *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

information as to which it has not opined. Under the PCAOB's proposed other information standard, however, the auditor would make affirmative statements about the other information, increasing the likelihood that allegations of liability would be made.

Even under our suggested approach, we note the auditor will still face increased risk for having made a statement about the other information. This is because the auditor's report would provide a description of the auditor's responsibilities for the other information (e.g., comparing the other information to the financial statements or the accounting records). Accordingly, the potential for increased litigation would remain. For example, a plaintiff might allege that the auditor knew the company misstated a material fact in MD&A; that the auditor failed to take adequate steps to correct that misstatement; and that, from the description of the auditor's responsibilities in the auditor's report, a reasonable investor would conclude that the auditor affirms that no such misstatement existed. Our suggested changes, in short, may reduce the additional liability risk, but would not eliminate it.

Additional Addressees in the Auditor's Report

The proposed auditor reporting standard would require addressees of the auditor's report to include "(1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body."⁴² The proposal further suggests, however, that the report "could" be addressed to others, such as bondholders.⁴³ It is unclear whether the PCAOB is contemplating requiring the auditor to consider whether it must address the auditor's report to others (beyond shareholders and the board), or is merely suggesting that auditors consider doing so depending on the circumstances.

While many auditing firms currently address their auditor's reports to shareholders and the board, we do not see a basis for requiring – or even suggesting – that the report be addressed to additional parties. Any such addition to the addressees might permit such parties to assert that they are owed a duty of care by the auditor, which would expand the auditor's liability risk.

Under applicable state law, an audit firm and the client who engages it have a relationship of privity, which gives the client legal rights that others do not have. However, a particular third party may, under the law in some states, be able to establish the existence of a relationship with the auditor giving it the same rights as a client by demonstrating (1) that the audit firm knew the third party's identity and that it was relying on the auditor's report, and (2) conduct by the auditor linking it to the third party and its reliance. Even though the addressing of the auditor's report is not intended to create such a relationship, a court may find that one in fact existed based, at least in part, on including a third party as an addressee of the report, thereby creating undue incremental litigation risk without increasing the value of the report to users.⁴⁴ Adding addressees to the auditor's report will not affect those with access to it: the auditor's report is a general use report available to all capital market participants – shareholders, bondholders, rating agencies, analysts, and others – that the issuer can distribute without restriction, and to which third parties have ready access via the issuer's SEC filings.

⁴² See the proposed auditor reporting standard, paragraph 6(b).

⁴³ See the proposal pages A5-8 through A5-9.

⁴⁴ See *Futureselect Portfolio Management, Inc. v. Tremont Group Holdings, Inc.*, 175 Wash.App. 840, 309 P.3d 555 (2013); *Anwar v. Fairfield Greenwich Limited*, 884 F.Supp.2d. 92 (S.D.N.Y. 2012).