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August 18, 2017

Re: File No. PCAOB-2017-01

Public Company Accounting Oversight Board;
Proposed Rules on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures from Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Mr. Fields:

We are submitting this letter in response to the request by the Securities and Exchange Commission for comment on the Public Company Accounting Oversight Board's proposed standards referenced above (the "**Proposed Standards**"). We appreciate the opportunity to comment on the Proposed Standards.

Under the Sarbanes-Oxley Act of 2002 and the Securities Exchange Act of 1934 (as amended), in order for the Commission to approve a proposed rule of the PCAOB, it must find that the rule is consistent with the Sarbanes-Oxley Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors.[1]

The PCAOB states that the adoption of the Proposed Standards "responds to the strong interest of investors for enhanced communication about the audit" and is consistent with its mandates to protect investors and further the public interest in the preparation of informative, accurate and independent audit reports.[2]

[1] See 15 U.S.C. § 7217(b)(3) – (4) and 15 U.S.C. § 78s(b)(2).

[2] The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Auditing Standards (PCAOB Release No. 2017-001) at 1 (June 1, 2017) ("Release").

However, consistent with our comments to the PCAOB in 2013 when the standard was first proposed, [3] we question whether the Proposed Standards relating to a "critical audit matter" ("**CAM**") would provide the intended benefits in a manner that would justify the additional costs and other potential adverse impacts to companies, their audit committees and auditors. We also do not believe that the disclosure of auditor tenure required by the Proposed Standards should be compelled in the auditor's report and recommend that the PCAOB include such disclosure elsewhere.

Our concerns are as follows. First, CAM disclosure substantially overlaps with disclosure already provided by public companies, and the new information would likely provide unclear or minimal additional value compared to the likely costs. Second, the increased auditor liability risk that would result from CAM disclosure is likely to lead to lengthy and boilerplate disclosure. Lastly, we note the cost of CAM disclosure would be borne by the public company and would require additional resource allocation to the financial reporting and compliance functions, which could outweigh the value to investors CAM disclosure would provide.

CAM Disclosure Would Largely Overlap With Existing Management Disclosure, and New Information Would Likely Provide Minimal Benefits

Under the Proposed Standards, auditors would be required to disclose CAMs in a new section of the audit report or affirmatively state that there were no CAMs for that period. A CAM is defined as "a matter that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment."[4] For each CAM that is identified, the auditors would describe the CAM, the principal considerations that led the auditor to believe that the matter is a CAM, how the CAM was addressed in the audit, and the relevant financial statement accounts or disclosures related to the CAM.[5]

As defined, CAMs would almost certainly include all of a company's "critical accounting policies," which Section 204 of the Sarbanes-Oxley Act requires auditors to report to the audit committee and which U.S. public companies disclose as part of "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("**MD&A**") in the Annual Report on Form 10-K.[6] Given the substantial overlap, and given the participation of auditors in the formulation and review of critical accounting policies, we expect that auditors would start with critical accounting policies in public company disclosures in formulating any CAMs.

In the case of overlapping critical accounting policies and CAMs, the additional information that the auditors would provide is a discussion of how they identified and addressed the CAM in the audit. While we understand some investors are interested in receiving audit information as an additional source of information about a company's financial statements, the PCAOB particularly mentions the complexity of the company's accounting estimates and fair value measurements as a reason why

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[3] Davis Polk & Wardwell LLP, Comment Letter on PCAOB Rulemaking Docket Matter No. 34 (Dec. 11, 2013).

[4] Release at 11.

[5] Release at 12.

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

additional disclosure is needed.[7] But this disclosure is already provided by management to investors in MD&A, and auditors already review the MD&A before it is published.

Despite concerns shared by commenters, under the Proposed Standards, this new information could include sensitive information about a company not previously disclosed or even required to be disclosed under the financial reporting rules applicable to registrants.[8] Competitive disadvantages to companies could result from disclosure of sensitive information.

Given the effort that compliance with CAMs would entail on the part of auditors, audit committees and company management (as we discuss separately in this letter), it remains unclear what benefit, if any, this largely duplicative disclosure would provide. To the extent that CAMs mirror the company's critical accounting policies already required to be disclosed, the informational value would be minimal or nonexistent. To the extent they summarize matters on which the engagement team needed to consult with their national office, they may be saying more about the experience of the individual auditors than the quality of the company's financial disclosures. One expected benefit of CAMs noted by the PCAOB is the ability for auditors to differentiate themselves based on the quality of their disclosure of CAMs.[9] However, by triggering potential disclosure of CAM based on referral to their national office, the PCAOB may be setting up a system in which the differentiation is not based on the quality of the final disclosure but merely on the number of times a matter is referred to the auditor's national office.

Heightened Liability Risk Will Likely Contribute to Boilerplate

As the class-action litigation environment is a significant challenge to the health and success of U.S. public companies and PCAOB-registered accounting firms, the auditor's discussion of CAMs would surely not occur in a risk-free vacuum. Because of this increased exposure to disclosure-based securities liability claims, auditors would be heavily incentivized to include *all* non-trivial issues communicated to the audit committee regarding the audit, including the company's critical accounting policies, notwithstanding the CAM identification framework. The reality is that the auditors are at a risk of being sued on the basis of their report in the event of a financial restatement or other financial difficulties at the company. Despite the favorable comparisons to the Proposed Standards and U.K. practice cited by the PCAOB in its proposal, we believe the Commission should take into consideration the fact that U.S. public companies and PCAOB-registered accounting firms operate in a different legal environment from U.K. companies and auditors, and have far greater exposure to liability claims brought by investors. This disparity leads us to the conclusion that a similar requirement in the United States would be interpreted and applied quite differently, in a manner that is both more time-consuming and expensive, and ultimately of less value to investors.

Auditors are likely to view discussion of CAMs in their report as a shield against litigation. We also anticipate that auditors will more frequently involve counsel in preparing or reviewing disclosure for legal risk. Auditors will not want to be second-guessed by plaintiffs' lawyers applying hindsight in the case of litigation and will not want to try to explain why some matters discussed with the audit

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[7] Release at 65.

[8] See Release at 34 ("The final standard…retains the note from the reproposal explaining that the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.").

[9] See Release at 83 ("[E]xpanded auditor reporting should serve as a potential means of greater differentiation among accounting firms and engagement partners.").

committee were disclosed as CAMs but others were not. The inclusion of CAMs in audit reports will likely be seen to provide protection to auditors in the same manner that risk factors are thought to provide protection to companies. As a result, there will be little incentive to make big changes in disclosure year-over-year and the number of CAMs included in audit reports is likely only to proliferate over time. This will contribute to the length of audit reports and the related public company filings. Similar to public company disclosure practices, if any auditor includes a CAM with respect to a company in a particular industry, other auditors will be incentivized to include a comparable CAM to avoid the litigation risk attendant to appearing to be an outlier.

In adopting the Proposed Standards, the PCAOB did not repeat the illustrative disclosures contained in the reproposing release[10] because it did not want them to become *de facto* templates for CAM disclosure.[11] However, it should be noted that such disclosures ranged from several paragraphs to more than a page of additional language for each CAM.[12] This range multiplied by the number of CAMs a company is likely to have would dramatically lengthen the audit report. As a consequence, rather than enhancing an investor's understanding of financial reporting, CAMs could undermine the benefits of the audit report's current pass/fail model.

Costs of Public Company Disclosure

CAMs will appear in the company's filings and will potentially provide the basis for liability against the company. We therefore believe that companies will insist on reviewing, negotiating and approving all CAMs before the audit is finalized.

Because one of the triggers for requiring the auditors to consider whether a matter is a CAM is that it has been, or was required to be, communicated with the audit committee, the Proposed Standards could chill communications between the auditors and the audit committee. At the same time, because the engagement team will recognize that communications with the national office will likely trigger a need for CAM disclosure (and may be seen as a negative differentiation between auditors), we believe that a requirement to discuss CAMs in the audit report could have a chilling effect on these discussions as well. Inhibited communications will hinder the ability of audit committees to fulfill their oversight responsibilities and will not have a healthy impact on the quality of public company financial reporting. Existing auditing standards promote an open dialogue between auditors and audit committees precisely because this communication results in better disclosure.[13]

The PCAOB stated that it anticipated that the new standard would result in potential additional costs but also stated that it was unable to quantify the costs.[14] Given the likely length and scope of a company's CAMs and our anticipation that CAM disclosure will be the subject of discussion with management and audit committees, we anticipate that the effort to analyze, draft and negotiate them would be significant, would raise the cumulative costs of financial reporting and compliance and

[10] PCAOB Proposed Auditing Standard-The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (PCAOB Release No. 2016-003) (May 11, 2016).

[11] Release at 29, note 47.

[12] *See* PCAOB Release No. 2016-003 at 32-35.

[13] "The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors." PCAOB Auditing Standard No. 16 – Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380 (PCAOB Rel. No. 2012-004) at 2-3 (Aug. 15, 2012).

[14] Release at 86.

would increase pressure on management, audit committees and auditors during already hectic annual reporting periods. The PCAOB stated that their analysis of the increased costs for audits of U.K. companies subject to similar disclosure requirements to the CAM disclosure proposed here found no statistically significant difference in audit fees but showed a 5% increase in average audit fees.[15] The PCAOB also acknowledged that audit fees do not fully reflect the costs of implementing expanded auditor reporting, which would include any costs that the accounting firm would choose to absorb and the additional demands on management's time.[16] We believe that any expectation that added costs would be minimal is at odds with the PCAOB's description of the process involved – which includes the attention of the senior members of engagement teams; the attention of the engagement quality reviewer; consultations with others, including the auditor's national office and specialists; and discussions with management or the audit committee; developing new management and audit committee processes and legal review of CAM communications.

Auditor Tenure

The PCAOB added a requirement to include in the audit report the number of consecutive years the auditor has been engaged by the company. However, there is no generally recognized understanding as to how the length of auditor tenure positively or negatively impacts audit quality. The Commission's Chief Accountant recognized this recently in remarks addressing audit tenure as one of several factors to be considered by audit committees:

> These are only several considerations, recognizing that years of service is often a matter to be evaluated in the context of company- and firm-specific facts and circumstances. In doing so, it is useful to keep in mind that the PCAOB's standard . . . notes that existing research on any relationship between an auditor's tenure and either audit quality or auditor independence has varied conclusions.[17]

We feel that disclosure of auditor tenure may skew the market for auditors due to a perceived, but unproven, negative association between lengthy auditor tenure and either audit quality or independence. If the Commission believes that disclosure of auditor tenure is appropriate, then we believe that it would be more properly disclosed in context on Form AP along with other disclosures about the auditors.

Conclusion

The proposed standard appears to be significantly driven by the belief that it could alleviate the information asymmetry that exists between investors and auditors, thereby reducing the information asymmetry that also exists between investors and company management.[18] We do not believe these very general goals provide an adequate rationale for the fundamental change and dramatic expansion of the audit report with its increased costs, almost inevitable delays and potentially serious unintended consequences with respect to communication and consultation. We remain skeptical that company auditors are better positioned than the company itself to address the information gap between investors and company management. The auditors are third parties who

[15] Release at 88.

[16] Id.

[17] Bricker, Wesley R., SEC Chief Accountant, Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets" (June 8, 2017), citing Release at 95.

[18] Release at 67.

have expertise in assessing whether the company's financial statements are presented in accordance with generally accepted accounting principles, but do not have expertise in communicating with the marketplace. If more disclosure is in fact necessary, we suggest that it be provided by the company through Commission rulemaking or the accounting standard setting process.

We note that the PCAOB stated that it was unable to quantify the potential additional costs of its proposal but we encourage the Commission and the PCAOB to further study these costs as the Commission evaluates the objectives of the Proposed Standards.[19] Should the Commission approve the Proposed Standards, given the possibility of further increasing the substantial financial reporting costs to companies, we suggest a prudent course would to be delay implementation of any new standard until reliable cost estimates (in both time and money) can be developed or are available from other jurisdictions which have only recently introduced similar measures.

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We appreciate the opportunity to comment, and would be pleased to discuss our comments or any questions the Commission or its staff may have, which may be directed to Joseph A. Hall, Sophia Hudson, Michael Kaplan, Richard J. Sandler, Nicole Green or Jennifer Fitzpatrick of this firm at 212-450-4000.

Very truly yours,

Davis Polk & Wardwell LLP

[19] Release at 86.