August 21, 2017

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

Re: Public Company Accounting Oversight Board: Notice of Filing of 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 (Release No. 34-81187; File Number PCAOB-2017-01)

Dear Mr. Fields:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") Proposed Auditing Standard on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (the "Proposed Standard"), filed with the Securities and Exchange Commission ("SEC" or "Commission") on July 19, 2017.[1] The undersigned of this letter are all members of the Standing Advisory Group at the PCAOB. We would like to emphasize, however, that the views expressed herein are our personal views and do not necessarily represent those of the Board, the Board members, the Board staff, the SAG or other members of the SAG. As our personal views, they also do not necessarily reflect the views of any organization with which we are affiliated.

As members of the SAG, many of us have had an opportunity both to provide input on this matter and to observe the deliberate process employed by the PCAOB in its development. In developing AS 3101, the PCAOB has relied on an inclusive and thoughtful approach. All stakeholders affected by the proposal have had an opportunity to contribute to the discussion and the final version adopted by the PCAOB reflects these varied views. We strongly support AS 3101 and urge the Commission to adopt this proposal.

I. Overview

AS 3101, the proposed standard, would alter the contents of the auditor's report. In particular, the report would require a discussion of critical accounting matters ("CAMS").[2] The

[1] The language of the new standard can be found here: https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf
[2] The report also must include the tenure of the auditors and other changes designed "to clarify the auditor's role and responsibilities, and make the auditor's report easier to read."

requirement applies to matters involving "especially challenging, subjective, or complex auditor judgment" that are reported to the audit committee and relate to an account or disclosure that is material to the financial statements. As a result, investors and others who use and rely on the financial statements will receive increased disclosure of "significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements."[3] CAMS will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance.

AS 3101 represents an appropriate and balanced updating of the auditor report. The revisions are designed to benefit investors by conveying a more complete perspective on the company's financial condition. The standard will ensure that investors understand the uncertainty inherent in the financial statements they rely on. Even as financial statements have incorporated increasingly more subjective estimates, the magnitude of stock price changes at earnings announcements has increased substantially, indicating that investors have placed ever greater weight on earnings and financial statement information over the past decade.[4] AS 3101 will also improve communications between the auditors and the audit committee and the quality of the audit process.

A. Costs and Benefits

AS 3101 will require auditors to produce a longer and more substantive report. In developing this reform, the PCAOB carefully adopted a standard that should not require changes to the audit process and that minimized the costs of producing such a report. AS 3101 applies only to matters that already must be identified by auditors in the course of audits, documented during the course of their work, and resolved as part of the audit procedures and process. Moreover, CAMS are limited to matters that must be (or otherwise are) reported to the audit committee. As a result, the concept of a CAM is well understood by those performing audits and their identification requires no meaningful change in the auditing process.

At the same time, the benefits of AS 3101 are substantial. Disclosure will provide investors with information that facilitates a better understanding of the financial statements and more informed decision making. The increased disclosure also benefits investors by improving audit quality and professional skepticism and by improving management's oversight of the audit.[5]

[3] PCAOB Release No. 2017-001 (June 1, 2017), at 2.
[4] For discussion of increased uncertainty in financial statement information, see Lev, Baruch and Feng Gu, ***The End of Accounting and the Path Forward for Investors and Managers*** (Wiley, 2016). For evidence of significantly increased price response at earnings announcement dates,. See Beaver, W. H., M. McNichols and Z. Wang, "The information content of earnings announcements: new insights from intertemporal and cross-sectional behavior," Forthcoming, *Review of Accounting Studies*, 2017.
[5] See J. Robert Brown, Jr., *Essay: Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure*, 57 Cath. U. L. Rev. 45 (2007).

In addition, the public reporting of CAMS will likely result in improved communications between auditors and audit committees.[6] The proposed requirement is limited to matters that must be or are reported to the audit committee. Audit committees are, therefore, already in a position to discuss these matters with the auditor.

AS 3101 provides a framework for discussion between auditors and audit committees. Audit committees should have a particular interest in matters communicated by the auditor that are likely to be made public in the audit report. The audit committee will likely want to more fully understand any auditing matter that applied to a material portion of the financial statements and that required "especially challenging, subjective, or complex auditor judgment."

B. The Disclosure Role of the Auditor

The standard effectively imposes additional disclosure obligations on auditors. The approach does not, as some have asserted, usurp the responsibility of management. The proposed standard was designed to make certain that the information included in the report was uniquely known to the auditors. Management is not in a position to independently know what matters are "especially challenging, subjective, or complex" to the auditor or to fully understand why this was the case.

Auditors will be required to provide a draft of the report to, and discuss the contents with, the audit committee. Moreover, management will also have an opportunity to respond to, or supplement, the disclosure in the report. Management's discussion and analysis represents an obvious location for such analysis.[7]

C. Materiality

AS 3101 applies a materiality standard to the disclosure required in the audit report. Specifically, the CAM need only be included in the report to the extent relating to "accounts or disclosures that are material to the financial statements. . ." The materiality analysis, therefore, does not apply directly apply to the CAM but depends upon the matter appearing in the financial statements.

In adopting this standard, AS 3101 avoided a change to existing auditing standards. With respect to the obligation to report "significant unusual transactions" to the audit committee, for example, existing standards do not define these transactions through application of a materiality

[6] PCAOB Release No. 2017-001, at 18 ("For matters required to be communicated to the audit committee, the Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing. It would seem that any chilling effect would more likely relate to matters that are not explicitly required to be communicated to the audit committee, although given the broad requirements of AS 1301 (particularly paragraph .24), the Board believes that there may be few, if any, relevant communications affected by that possibility.").

[7] See Item 303 of Regulation S-K, 17 CFR 229.303.

standard. Instead, significant unusual transactions are those that fall outside the normal course of business or that "otherwise appear to be unusual due to their timing, size, or nature."[8]

The approach taken by AS 3101 is designed to provide investors with the necessary information in a manner that minimizes disruption and cost to the existing audit process. Auditors can continue to apply the traditional analysis on whether matters should be reported to the audit committee. In preparing the report, auditors need not reexamine every matter considered in the course of the audit to determine materiality but only to identify those matters that relate to material aspects of the financial statements.

II. Conclusion

AS 3101 began in 2008 with a recommendation by the Advisory Committee on the Auditing Profession, a committee operating under the auspices of the US Department of Treasury and consisting of a broad spectrum of participants, including representatives of investors, auditors, and audit committees.[9] The final proposal emerged after a six-year process at the PCAOB and reflects an updating of the auditor report that has remained basically unchanged since the 1940s. The process provided all stakeholders with an opportunity to participate in the debate and comment on drafts. The version that emerged was a compromise that took into account the concerns raised by all sides.

The proposal also brings audit reports into closer alignment with reforms in the global markets. Auditing firms with operations in the United Kingdom have experience preparing these reports. The additional disclosure has benefited investors. An analysis shortly after implementation noted that, while some reports included boilerplate, others "contribute[d] significantly to investor understanding."[10] A year later, the analysis concluded that "the quality of risk discussion has improved . . . Most reports now include detailed discussion of the risks identified by the auditor, and generic risks have been dropped."[11] The reports have been positively received by investor groups.[12]

These changes are overdue. We strongly urge the Commission to adopt this standard as proposed.

Sincerely,

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[8] See https://pcaobus.org/Standards/Auditing/Pages/AS1301.aspx

[9] Final Report, Advisory Committee on the Auditing Profession, Oct. 6, 2008, at 17 ("The Committee believes this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements."), available at https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf

[10] New UK Auditor's Reports, Citi Research, March 2014.

[11] New UK Auditor's Reports, Citi Research, Sept. 2015.

[12] See Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Brent J. Fields, Secretary, Securities and Exchange Commission, Aug. 8, 2017, available at https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2197606-160364.pdf

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