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August 24, 2017

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SEC Release No. 34 – 81187 (the "Release"); File No. PCAOB-2017-01; *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.*

Ladies and Gentlemen:

The Securities and Exchange Commission (the "SEC") has solicited public comment on whether the new auditing standard (the "Proposed Standard") adopted by the Public Company Accounting Oversight Board (the "PCAOB") providing, inter alia, for a revised auditor's report that would identify and discuss critical audit matters ("CAMs") should be approved by the SEC as being consistent with Title I of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). Because we believe the inclusion of CAMs in the Proposed Standard in the manner adopted by the PCAOB is neither in the public interest nor necessary or appropriate for the protection of investors – and thus is not consistent with Title I – we appreciate the opportunity to submit this comment to the SEC.

I. Introduction

We have commented to the PCAOB on its original proposal to expand the auditor's report to make it more informative for investors and on the successive reproposals culminating in the Proposed Standard now subject to SEC approval.[1] Although we believe those efforts have merit, we also believe the benefit to investors of the proposed additional information to be included in the Proposed Standard is significantly outweighed by the cost it would impose on the capital formation process. Chairman Clayton has spoken about the importance of expanding opportunities for Mr. and Mrs. 401(k) to invest in our public markets and has emphasized that when the SEC writes its own rules, it is essential for the SEC to determine whether any objective, such as providing additional information to investors, can be achieved at a lower societal cost.[2] As we will discuss below, applying those principles to evaluating whether the SEC should approve the Proposed Standard as written militates against approval.

II. Adverse Consequences of the Proposal

The Proposed Standard is problematic in two significant respects: it will require auditors to provide additional original information about the issuer, even if the information is commercially sensitive and not required to be disclosed by the federal securities laws or the SEC's rules and regulations thereunder; and it will chill communication between the audit committee and management, on the one hand, and the auditors, on the other. Failing to address these concerns in a more meaningful way than reflected in the Proposed Standard will impose a cost on the disclosure process – and on capital formation more generally – that in our view outweighs the benefit. Moreover, as we discuss in Part III below, the benefit of additional information, including from an independent source, can be accomplished in a less costly – and therefore in a far preferable – manner.

A. Displacing SEC Oversight of Issuer Disclosure Requirements Through PCAOB Regulation of Auditors

The Proposed Standard requires the auditor to disclose and discuss CAMs, which are not otherwise required to be disclosed by the federal securities laws or the SEC's rules and regulations thereunder. As a result, the auditor may be required to be the source of additional original information about an issuer that the issuer itself has not disclosed. Although the PCAOB acknowledges the costs and potential unintended consequences associated with the CAM requirement,[3] it concludes those risks cannot be avoided or even materially mitigated to accomplish the goal of CAM disclosure. We disagree.

First, the PCAOB observes that nothing prohibits such disclosure and cites, in support, two examples: (1) addressing the going concern issue (which we note is now also required to be

[1] Comment letters of Cleary Gottlieb Steen & Hamilton LLP dated October 14, 2011, December 23, 2013 and August 15, 2016.

[2] See, e.g., Remarks by Chairman Clayton at the Economic Club of New York, I.D.

[3] Release at 14.

addressed directly by the issuer[4]), and (2) illegal acts. Both, in our view, are readily explained. The going concern qualification is fundamental to the basis on which an auditor assesses fair presentation. And auditor reporting of illegal acts, as Section 10A of the Exchange Act requires – which we note is disclosure to the SEC but *not* to the public – is justifiable where the company declines to do so itself.

These special cases, however, do not speak to sound disclosure policy, which we continue to believe should be the responsibility of the issuer and therefore under the oversight of the SEC to permit appropriate balancing of the very competing interests at play here: the benefit to investors of additional information, including from an independent source, versus the cost to issuers – in terms of audit fees and management time, heightened liability for what can be challenged in hindsight (in a putative class action) as untimely disclosure, and the competitive harm and unpredictability of being required to disclose commercially sensitive information. These costs could fairly be perceived by issuers as substantial.

We recognize our concern rests on a policy judgment rather than a legal prohibition, but it is a policy judgment we believe is shared by the SEC. In discussing PCAOB Release No. 2013-009, *Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits* (Dec. 4, 2013), the SEC opposed disclosure of auditor information anywhere other than the auditor's report, stating that "requiring any disclosure by the audit committee would require [SEC] action because the PCAOB does not have authority over issuer disclosures." Although the Proposed Standard does not purport to require an auditor to author disclosure anywhere outside the auditor's report, it does require auditors to provide information about an issuer that the issuer may not have previously made public; the location of that information seems irrelevant to whether the SEC rather than the PCAOB has the authority to require it.

Close consideration by the SEC of the impact of the Proposed Standard on issuer disclosure in determining whether to approve the Proposed Standard is particularly important and timely in view of the SEC's comprehensive review of its disclosure policy. In the recent SEC release, "*Business and Financial Disclosure Required by Regulation S-K,*" the SEC describes the costs and benefits of requiring disclosure, weighing the interests of investors and issuers. The benefits of additional disclosure, such as reducing information asymmetries between management and investors, that may result in more efficient investment and voting decisions, must be weighed carefully against the costs to issuers, including the incremental costs of producing the additional information, subject to appropriate controls, and the competitive harm that can result from such disclosure.

A good example of balancing incremental disclosure against the adverse impact on issuers is the debate some time ago (2008-2012) over the disclosure that should be required under Accounting Standards Codification 450, *Contingencies* ("ASC 450"), such as asserted or unasserted claims, that may affect future financial reporting. The Financial Accounting

[4] FASB Accounting Standards Update (ASU) No. 2014-15, Presentation of Financial Statements—Going Concern (Subtopic 205-40).

Standards Board ("FASB") proposed[5] and then reproposed[6] expansion of the disclosure requirements for contingencies but ultimately decided not to require any changes because, we believe, of the substantial harm to issuers that could result from premature disclosure of these matters. We are concerned that the Proposed Standard CAM disclosure requirements will produce that very result, and it is no more justified in this context than it was with respect to ASC 450.

The PCAOB also observes in the Release[7] that the issuer will be given the opportunity to expand its disclosure to address a CAM, thus suggesting that it will be able to gain control over that incremental disclosure. It is certainly the case that the views of auditors as to what is required issuer disclosure can have an impact, and sometimes a decisive impact, on what issuers disclose. However, that role for an auditor in the issuer disclosure process is a very different one than empowering the auditor to drive issuer disclosure not required by any federal securities law or SEC requirement. If the audit committee and management choose to disclose the information related to an auditor's CAM disclosure under these circumstances, they would be doing so to restore the issuer's control over disclosure, and not because they believe the disclosure is required under existing securities laws or SEC regulations or otherwise is appropriate. That is not a choice that issuers or audit committees should be forced to confront.

Two last points to highlight regarding the policy judgment we believe the SEC should make in determining whether to approve the Proposed Standard insofar as it requires incremental disclosure by auditors of issuer information. First, the PCAOB notes that it has considered carefully commenters' concerns about incremental litigation risk to both issuers and auditors and has determined those risks do not outweigh the benefits of the expanded disclosure provided by the CAM requirements.[8] That is precisely the kind of policy judgment about the scope of issuer disclosure that should ultimately be made by the SEC, particularly because the heightened liability risk faced by companies (and auditors) is notably greater in the United States than in other countries in which regulators have imposed similar incremental disclosure requirements.[9]

Second, we believe the disclosure policy determination made by the PCAOB in adopting the Proposed Standard is inconsistent with the concerns that led Congress to include Section 104 in the Jumpstart Our Business Startups Act (the "JOBS Act"). As acknowledged by the PCAOB,[10] the additional disclosures required for CAMs – not just in identifying them but in discussing why they are CAMs and how they were addressed by the auditors – are similar to the augmented auditor disclosure that would have been included in the auditor discussion and analysis concept raised, but ultimately rejected, by the PCAOB and barred by Section 104 from being imposed on emerging growth companies ("EGCs"). Accordingly, the PCAOB determined not to apply the CAM requirements to audits of EGCs.

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[5] Exposure Draft, *Disclosure of Certain Loss Contingencies* Issued June 5, 2008.
[6] *Proposed Accounting Standards Update Contingencies* (Topic 450) Disclosure of Certain Loss Contingencies Issued July 20, 2010. The project was removed from the FASB agenda on July 9, 2012.
[7] Release at 15.
[8] Release at 18-20.
[9] A recent study found that federal securities class action litigation filings rose to their highest level in 20 years in 2016, 44% above the 1997-2015 historical average. Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, Securities Class Action Filings – 2016 Year in Review (January 31, 2017).
[10] Release at 54-55.

The test to be applied by the SEC under Section 104 of the JOBS Act in assessing whether PCAOB rules should be applied to EGCs expressly requires the SEC to take into account the effect of a PCAOB rule on capital formation. We believe the SEC should also take that factor into account in determining, under the Sarbanes-Oxley Act, whether a proposed PCAOB rule is "necessary or appropriate in the public interest or for the protection of investors."[11] Certainly that is true for determining what is in the "public interest."[12] We also submit it is clear the incremental CAM disclosure is not "necessary" for the protection of investors.[13] Whether it is "appropriate" is a matter of judgment, and it is up to the SEC to make that judgment, taking into account the same calculus that underpins other disclosure judgments the SEC makes and will be making, inter alia, in its disclosure effectiveness project. In Part III below, we propose an alternative to the CAM requirements we believe strikes the right balance.

B. Chilling Effect on Auditor Communications with the Audit Committee and Management

As described above, the Proposed Standard requires the auditor to disclose original information about an issuer that is not otherwise required to be disclosed under the federal securities laws or SEC regulations. Any requirement that risks interfering with open and robust communications between audit committees and management, on the one hand, and auditors, on the other, undermines the relationship between issuers and auditors, and, ultimately, the safeguards to investors provided by the important gatekeeping role played by the auditor. In our experience, open communications between audit committees and management, on the one hand, and auditors, on the other, produce better financial reporting.

We of course in most cases represent the issuers in circumstances where we are privy to audit committee or management interactions with auditors. However, we believe we are unbiased observers regarding the advantages to all sides — companies, boards, auditors and investors — of full and open communication between management, audit committees and auditors. Any regulatory action that would run the risk of adversely affecting that communication should be avoided unless there is great advantage to markets, investors and other parties as a result. As we have noted, we believe the advantages of the Proposed Standard are conjectural. Based on our experience, we can assure you that the risk of chilling communications is real and neither conjectural nor speculative.[14] That good financial

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[11] Sarbanes-Oxley Act, Section 107(b)(3).

[12] See, e.g., Memorandum from SEC Division of Risk, Strategy, and Financial Innovation and Office of General Counsel to Staff of the Rulewriting Divisions and Offices, Current Guidance on Economic Analysis in SEC Rulemakings, Mar. 16, 2012, available at https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf. The Memorandum states, in pertinent part: "The Commission has long recognized that a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest."

[13] To conclude that the incremental CAM disclosure is "necessary" would be to ignore not only the SEC's existing and substantial disclosure requirements principally in Regulations S-K and S-X, but also the SEC's catch-all rules (Rule 408 under the Securities Act and Rule 12b-20 under the Exchange Act) that require the disclosure of "further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

[14] The PCAOB has acknowledged that, in a study of audit committee behavior, study participants assuming the role of management chose to be less forthcoming with information when they were aware that auditors could use the

management, audit committees and audit engagement partners will seek to combat the risk is not a complete solution, or even an acceptable one.

III. An Alternative Approach

Despite our concerns, we reiterate that we welcome the PCAOB's commitment to improving the usefulness of the auditor's report to investors, and we believe in improving transparency between issuers and investors in a balanced fashion that considers the interests of both constituencies. We agree with the PCAOB that there is a salutary purpose in requiring auditors to identify CAMs to arm investors and analysts with information needed to engage management with targeted questions about CAMs, which the PCAOB believes may also lead to improved audit and financial reporting quality.[15]

That result can be accomplished, however, without requiring auditors to explain why they identify certain matters as CAMs or how they address them in the audit. Limiting the incremental requirement to identifying CAMs will meaningfully address our two principal concerns – leaving disclosure judgments about issuer information to management and audit committees, consistent of course with SEC disclosure requirements, and preserving open communication between them and the auditors. Equally important, it will not only highlight issues for investors and analysts to explore with management, but it will also serve as an effective check by the auditors on management's compliance with the SEC's requirement that companies disclose critical accounting estimates and assumptions that "may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance."[16] That MD&A requirement is, in many ways, similar to the standard for CAM disclosure under the Proposed Standard.

In formulating our proposal, we considered eliminating the requirement to describe why auditors identified matters as CAMs but not how they addressed them in the audit. Although the risks of forcing disclosure not required by the SEC – for example, whether a matter was deemed a CAM because of the control environment (short of a material weakness) or the uncertainty over a litigation matter not ultimately deemed to require disclosure under Regulation S-K 103 or ASC 450 – and the chilling of communication are more clearly present in the "why" requirement than the "how" requirement, we ultimately concluded that the latter should be dropped as well for a number of reasons. First, we expect this description of audit procedures to become boilerplate both to limit auditor liability and to reduce audit costs and management time in discussing the description with the auditors. Second, while the two principal concerns we have expressed regarding the Proposed Standard are more clearly eliminated or mitigated by striking the "why" requirement, there would remain uncertainty regarding the content of the description of audit procedures to address CAMs that may lead to unwanted disclosure and the concomitant chill on communication we fear. Finally, we believe the judgment regarding whether the incremental

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information as the basis for a CAM. PCAOB Release No. 2016-003, *Proposed Auditing Standard -- The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (May 11, 2016) at 87.

[15] Release at 38-39.

[16] SEC Release No. 33-8350 (Dec. 29, 2003).

disclosures of audit steps to address CAMs provide sufficiently useful information for investors to outweigh the costs to issuers of forcing disclosure of issuer information not otherwise required by the SEC or the federal securities laws is, as we have noted, one for the SEC to make.

By implementing our proposed more limited version of CAM disclosure, the PCAOB can achieve the objective of reducing asymmetries in information between management, on the one hand, and analysts and investors, on the other, while deferring to the SEC's role as overseer of issuer disclosure and maintaining open and robust communication between the audit committee and management, on the one hand, and the auditors, on the other. The SEC should require the PCAOB to do so.

IV. Post-Implementation Review

As is clear from our comments above, we do not favor SEC approval of the Proposed Standard. However, if the SEC does proceed to approve it, we believe it is crucial, given the uncertain nature of the benefits and the serious risks, for the SEC to accompany the approval with a mandatory directive to the PCAOB and the Office of the Chief Accountant to conduct a post-implementation review of the operation of the Proposed Standard after no more than two years following effectiveness. That review should address at least the following matters:

1. whether the inclusion of CAM identification and discussion in audit reports has provided information that is material to investors and markets (decision-useful to the reasonable investor in the context of the overall mix of information available);

2. whether the CAM discussion has resulted in either disclosure of issuer information in audit reports or has resulted in modifications to what would otherwise be disclosed in issuer filings, and in either case, whether the disclosed information is material to investors and markets or is harmful to issuers;

3. whether the disclosure resulting from the Proposed Standard is showing a tendency to devolve into boilerplate;

4. whether, based on information that can be obtained from auditors and issuers, there is information available regarding the impact of the Proposed Standard on communications among management, audit committees and auditors, and if so, what that impact has been; and

5. how the PCAOB inspection process has impacted CAM identification and discussion.

* * * * *

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

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: Securities and Exchange Commission
Hon. Walter J. Clayton, Chair
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
Hon. William Hinman, Director, Division of Corporation Finance
Hon. Robert Evans III, Deputy Director, Division of Corporation Finance