ICAEW REPRESENTATION
122/16

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

ICAEW welcomes the opportunity to comment on the *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* published by the PCAOB on 11 May 2016, a copy of which is available from this link.

This response of 11 August 2016 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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MAJOR POINTS

1. We congratulate the PCAOB on these revised proposals for auditor reporting. The further alignment with IAASB standards is particularly welcome and will benefit US investors. It will also benefit investors in Europe and elsewhere to the extent that the proposals are more closely aligned with the new EU audit legislation, effective 17 June 2016. The PCAOB is committed to research seeking to understand the outcome of enhanced auditor reporting. We applaud its support of rigorous and independent academic research not least because the data and information auditors will provide in the new audit report and Form AP will promote and facilitate innovative approaches to analysis and learning, particularly by academics. The information in UK audit reports already analysed, combined with the analysis of US audit reports and indeed reports from other jurisdictions should yield valuable insights into audit, auditors, companies and more. These insights will benefit US investors and investors worldwide, and should ultimately contribute, demonstrably, to the enhanced functioning of the US and global capital markets.

Alignment with the IAASB and the wider purpose of enhanced reporting

2. We are particularly pleased that the PCAOB has decided not to prescribe how CAM are to be described, and have instead developed a list of matters to be covered that is very similar to the list used by the IAASB. We noted in our response to the PCAOB's original proposals dated 11 December 2013 (ICAEW Rep 172/13) our belief in the importance of the PCAOB doing what it can to ensure that the apparent areas of difference between the different proposed reporting regimes are minimised. We noted that US investors investing outside the US and foreign investors investing in the US are unlikely to have the time or inclination to distinguish between the purported virtues of the different regimes, particularly where dual listed entities include audit reports prepared under both local and PCAOB standards in their filings.

3. We also noted:

   - that investors are unlikely to be convinced that wording differences in auditing standards will, in the long run, result in any significant differences in what is communicated. The depth and quality of auditor reporting will be driven by investor demand, the regulatory approach to monitoring auditors, the approach taken by audit firms and common practices that develop within and across industry sectors in the next few years.
   - that we did not believe that CAM as defined by the PCAOB and KAM as defined by IAASB were significantly different, even as they stood, and that the range, depth and detail of reporting would be similar, whichever regime applied. The closer alignment of the two regimes means that this is even more true now. Firms reporting under UK, US and international standards base their methodologies on ISAs and firm efficiency and practice risk management dictate that they will seek to align their reports across different regimes as far as possible.
   - our belief that the main threat to enhanced transparency is that CAM disclosed will be irrelevant, or degenerate into boilerplate.

4. While we have some concerns that the new regime will come to be seen as an end in itself we are confident that the power of data analytics will, over time, enable academics, investors, regulators and others to mine the information provided in the audit report and Form AP to yield valuable insights. Enhanced auditor reporting is the start of a journey whose purpose is to open up the dialogue between auditors, audit committees, investors and boards by providing everyone involved with a starting point for a discussion. This requires changes to existing patterns and modes of thinking and communication. To make CAM *effective*, investors, audit committees and auditors need to step up their level of engagement with each other. CAM will be relevant and useful to investors and other financial statement users provided:

- investors continue to engage with audit committees and auditors, and are clear about what they want to know;
- auditors avoid boilerplate where possible;
- regulators, companies and investors do not drive auditors into the defensive reporting of boilerplate with threats of sanctions and litigation.

The UK experience

5. The enhanced reporting regime has, to date worked well in the UK. The UK has a strong and mature profession and deep and liquid capital markets, in which the threat of litigation involving auditors arises relatively infrequently. In jurisdictions where these conditions are not present, it may be harder to make the change to enhanced auditor reporting effectively and the easier the new regime is made for all concerned to operate, the better.

6. We noted in our previous response that IAASB's documentation requirements, and those in the UK, focus on why KAM are KAM, whereas the PCAOB's requirements focus on documenting why possible CAM are not considered CAM. This seems to be more about preparing audit files for inspection than communicating information to investors. Firms approach the documentation of CAM in different ways. Some do start with all matters reported to the audit committee and put them into 'in' or 'out' buckets in determining whether they are also CAM. But other firms start with a list of significant risks, put them into 'in' and 'out' buckets for reporting purposes, and then determine what to report to the audit committee. Other firms again approach each exercise separately. We urge the PCAOB to think again about this requirement, and about how it will be enforced. The documentation requirements as they stand re-inforce the sense that the disclosure of CAM is an end in itself. If the dialogue between investors, audit committees and auditors is not significantly improved as a result of the new regime, a great deal of effort will have been wasted and we urge the PCAOB to continue to think about how it will encourage these communications, and about how it will measure the *effectiveness* of the new regime.

The nature and purpose of Form AP

7. We noted in our previous response that while we agree that information regarding auditor tenure is of *interest* to investors, we do not believe that the auditors' report is the right home for it. We are therefore pleased that the PCAOB is recommending inclusion of this information in Form AP. It would have been out of context in the audit report.

8. The evidence relating to the relationship between auditor tenure and audit quality is mixed and we note that two out of five of the PCAOB Board members are not wholly supportive of the proposals in this respect. We too have concerns. We remain of the view that the information provided will be fairly basic, that no form of words can cover every eventuality and that. misunderstandings and inconsistencies are therefore possible. Nevertheless, enhanced auditor reporting, as noted elsewhere in this response is the start of a journey and we expect that the PCAOB will monitor and finesse the nature and quality of the information in Form AP over time. The consistency provided by this reporting requirement will facilitate better quality academic work not least because academics currently have to construct their own data sets using their own assumptions regarding changes in firms and auditor tenure. The information will be publicly available and that of itself has value.

9. The PCAOB also needs to consider the nature and purpose of Form AP. Firms are currently making significant changes to their internal reporting mechanisms to fulfil the current requirements for the information required by Form AP. We encourage the PCAOB to

   - develop criteria for the inclusion of further information in this form;
   - consider its quality and its uses;
   - consider how information in this form and information in the audit report is to be distinguished.

There is a risk, otherwise, that unhelpful 'noise' will be created by Form AP, if it comes to house a large amount of basic data to which rudimentary analytical tools are applied by unskilled users. The PCAOB risks creating a rod for its own back if the only rationale for the inclusion of information in Form AP is that it is 'of interest' to some who strongly believe that there *is* a relationship between audit quality and audit tenure for example, and are determined to prove it, despite more rigorous academic evidence being inconclusive. Simply providing this information lends credence to the underlying but unproven assumptions about such relationships and the PCAOB is thereby, by implication, endorsing them. We are not convinced that the PCAOB is comfortable with this perception and we encourage the PCAOB to monitor the quality of the information in Form AP, and consider carefully how it is used and for what purposes.

10. We have not answered specific questions on issues that arise from PCAOB inspections or are specific to the US.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Is the definition of 'critical audit matter' appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.

11. There are no fundamental flaws in the definition and it is sufficiently clear to enable auditors to apply it consistently. However, we have concerns that regulatory, company and investor behaviour may encourage auditors to carry on including CAM, year after year, through *excessive emphasis on consistency* at the expense of applying the spirit of the requirements. It will always be easier to leave something in, rather than take it out, if auditors not only feel obliged to explain the change in the audit report, but then explain it again to investors and regulators.

12. We note elsewhere in this and previous responses our belief that there would be little if any difference in practice to what is reported if the PCAOB moved further in the direction of the IAASB's definition.[1] The only possible difference of emphasis is in the focus on materiality and while the IAASB standard focuses less on this, we believe it will be a rare set of circumstances indeed in which something is considered technically immaterial, but still relevant.

13. While terminology should be aligned between standard-setters wherever possible, we understand the limits to this. We therefore congratulate the PCAOB on using virtually the same words as the IAASB regarding the description of the matters to be covered by auditors. To have the confidence to do so is the mark of a mature regulator and we encourage the PCAOB going forward to continue to consider how it can best leverage the work of other standard-setters and, just as importantly, we will encourage other standard-setters going forward to consider how they can best leverage the work of the PCAOB.

14. Nevertheless, we remain uncertain about the rationale for the use of the term 'critical; rather than 'key'. While the IAASB and PCAOB definitions are different, as we indicate elsewhere in this response, we do not believe that combined effect of market pressure and audit firm desire for consistency will result in any significant differences in matters reported under the two regimes. While 'critical' can be read as a narrower category than 'key' in plain English - we are not sure how important that difference is to the PCAOB - if the PCAOB were to use the term 'key' rather than 'critical', we think there would little real danger that anyone would assume that the IAASB's regime had been applied.

[1] Matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements, as against matters that relate to material accounts or disclosures involving especially challenging, subjective, or complex auditor judgment

15. In achieving the Board's aim of providing relevant and useful information to investors and others the definition of CAM is probably less important than the behavioural drivers that will affect the quality of auditor disclosures. We note in our major points above our continued belief that auditor communication of CAM will be relevant and useful to investors and other financial statement users if:

- investors continue to engage with audit committees and auditors, and are clear about what they want to know;
- auditors avoid boilerplate where possible;
- regulators, companies and investors do not drive auditors into the defensive reporting of boilerplate with threats of sanctions and litigation.

16. We believe that the IMA awards in the UK which recognise excellence in auditor reporting are one way of encouraging stakeholders to engage with auditors, the audit process and auditor reporting, and that the PCAOB has a role in promoting this type of engagement with auditors to investors.

a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?

17. Matters communicated/required to be communicated to the audit committee is the appropriate source for CAM not least because it is aligned with IAASB's requirements.

b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.

18. There are no audit committee communications that should be specifically excluded from consideration as a source of potential CAM.

c. Is the 'relates to accounts or disclosures that are material to the financial statements' component of the definition of a critical audit matter appropriate and clear? Why or why not?

19. The 'relates to accounts or disclosures that are material to the financial statements' component of the definition of a critical audit matter is reasonably clear.

d. Is the 'involved especially challenging, subjective, or complex auditor judgment' component of the definition of a critical audit matter appropriate and clear? Why or why not?

20. The 'involved especially challenging, subjective, or complex auditor judgment' component of the definition of a critical audit matter is reasonably clear.

Q2: Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?

21. The factors listed are helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment although we are not clear as to why the factors refer to significant 'unusual' transactions in terms of the related work effort, rather than simply to 'significant' transactions.

22. The PCAOB should resist calls to add to this list. It is sufficient as it stands.

Q3: Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?

23. There are no factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment.

Q4: Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a re-audit? Why or why not?

24. We do not believe that there is any need for the PCAOB to prescribe specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented and we are pleased that the re-proposal regarding communication of prior period CAM does not mandate disclosure. Nevertheless, the PCAOB might wish to consider mandating auditor *consideration* of the disclosure of CAM for each period presented for any situation in which CAM in respect of prior periods have not been previously disclosed; for example, in the case of an IPO.

25. The PCAOB states that the change *allows auditors to include critical audit matters for prior periods when the auditor decides it is appropriate to do so*. On our reading of the proposals, the PCAOB appears to restrict communication of prior period CAM to those two circumstances. We believe that a more general permission is more appropriate.

Q5: Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?

26. We believe that the PCAOB should be clear that when it refers to consistent implementation, it is referring to the consistent identification of CAM, rather than consistent disclosure. The latter might encourage boilerplate by leading auditors in borderline cases to sticking to extant wording regarding a CAM identified in several consecutive periods, rather than changing it to reflect changes in circumstances, to avoid accusations of inconsistency and having to explain again to PCAOB inspectors why changes have been made.

27. We note in our major points that we are particularly pleased that the PCAOB has decided not to prescribe how CAM are to be described and have instead developed a list of matters to be covered that is very similar to the list used by the IAASB.

Q6: Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:

a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and

b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate? Are there other steps the Board could take to address these concerns? If so, what are they?

28. On rare occasions, auditors may have little choice about including original information about the entity in the audit report, particularly if management refuses, inappropriately, to disclose certain information in the financial statements and we believe that the manner in which the PCAOB deals with this is appropriate.

29. To the best of our knowledge, there have, to date, been no issues arising from investors or other financial statement users misinterpreting the UK equivalent of CAM as undermining the pass/fail opinion or providing separate opinions. Litigation aside, we see little reason why this should be an issue for US investors.

Q7: In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?

30. The PCAOB does not provide examples of situations in which auditors might refer to disclosures outside the financial statements and we cannot imagine any situations in which this might be appropriate. Such references would easily be misinterpreted as implying that auditors had audited or in some other way been more involved with the disclosure outside the financial statements beyond the requirements of existing PCAOB standards, which could lead to an expectation gap between investors and auditors.

Q8: Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and to require a statement to that effect?

31. It is appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, to require a statement to that effect in the auditor's report. The PCAOB may wish to consider adding to this situations in which the only CAM relate to certain modified audit reports, to bring it further into line with ISAs.

Q9: Is the reproposed documentation requirement clear and appropriate? Why *or why not? If not, how should the documentation requirement be formulated?*

32. The re-proposed documentation requirements are clear, but they could be improved. We note in our major points above different firms approaches to documentation and our belief that flexibility will help ensure that the disclosure of CAM do not become a compliance exercise and an end in itself. Some firms start with all matters reported to the audit committee and put them into ‘in’ or ‘out’ buckets in determining whether they are also CAM. Other firms start with a list of significant risks, put them into ‘in’ and ‘out’ buckets for reporting purposes, and then determine what to report to the audit committee. Other firms again approach each exercise separately.

33. IAASB requires the documentation of the rationale for inclusion as KAM, rather than exclusion. We urge the PCAOB to consider the extent to which it could move further towards IAASB’s position, by, perhaps, deleting the first requirement regarding the documentation of everything communicated/required to be communicated and leaving it at matters that involved especially challenging, subjective, or complex auditor judgment.

Q10: What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?

34. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q11: Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?

35. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q12: Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?

36. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q13: Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?

37. Despite the fact that IAASB has a similar requirement, we remain of the view expressed in our previous response that the inclusion of the statement regarding auditor independence is unnecessary, although some readers might welcome the clarification for the specific independence standards that have been complied with. We do not believe that inclusion of such language in the audit report will have any significant impact on auditor behaviour.

Q14: Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?

38. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q15: Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?

39. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q16: Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information they?

Q17: Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?

Q18: Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?

40. We note in our major points above our belief that Form AP is a better home for the information regarding auditor tenure than the audit report, mainly because the audit report is the wrong place for it, and that we have yet to be convinced about the value of this information. It is likely to be fairly basic because no form of words can cover every eventuality. Misunderstandings and inconsistencies are therefore possible. Nevertheless, we expect that the PCAOB will monitor and finesse the nature and quality of the information in Form AP over time. The consistency provided by this reporting requirement will facilitate better quality academic work because academics currently have to construct their own data sets using their own assumptions regarding changes in firms and auditor tenure. The information will be publicly available and that of itself has value.

41. We also note in our major points above our belief that some further thought needs to be given to the nature and purpose of Form AP. Firms are currently making significant changes to their internal reporting mechanisms to fulfil the requirements for Form AP. The PCAOB needs to think about the purpose of Form AP, its uses and the quality of the information it houses and how decisions are to be made regarding the inclusion of information in the audit report or Form AP. We see no justification for information such as auditor tenure, being included in both Form AP and the audit report.

42. Form AP should not be permitted to become a repository for a large amount of basic data to which unsophisticated users apply rudimentary analytical tools. There is a risk that this will happen if the only rationale for the inclusion of information in Form AP is that it is 'of interest' to some who strongly believe that there *is* a relationship between audit quality and audit tenure, for example, and are determined to prove it, despite more rigorous academic evidence being inconclusive. Simply providing this information lends credence to the underlying but unproven assumptions about such relationships and the PCAOB is thereby, by implication, endorsing them. We are not convinced that this PCAOB is comfortable with this perception and we encourage the PCAOB to monitor the quality of the information in Form AP, and consider carefully how it is used and for what purposes.

Q19: Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?

43. We are puzzled by this question partly because it seems more likely that search costs will, if anything, be greater if the information is included in the audit report as they are not aggregated and appear in different locations within a company's filing. Moreover, we think that requiring disclosure of auditor tenure is unlikely to make *any* significant difference to investor search costs, regardless of where the information is housed. Investors and others concerned with such issues are likely to be making comparisons across companies and taking account of many other variables.

44. If the Board does require disclosure in the auditor's report, a specific location, clearly distinguished from the rest of the report is important to avoid confusion regarding the significance of the disclosure and its relationship to the better quality information in the rest of the report.

Q20: Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?

45. The changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor are broadly appropriate and clear.

Q21: Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?

46. The interaction between the communication of critical audit matters and required explanatory paragraphs is clear.

Q22: Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?

47. Auditors *should* be permitted to include the very limited number of matters meeting the definition of a CAM and requiring explanatory paragraphs such as certain going concern issues, in the required explanatory paragraph. It is unlikely that many such reports will be issued and this approach would avoid confusion and maintain the alignment of the PCAOB's requirements with those of the IAASB in this relatively rare but nevertheless important area.

Q23: Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?

48. The requirement to include an explanatory paragraph when the auditor did not perform an audit of ICFR should apply in all cases, because readers may not be aware of the specific requirements regarding when management is required to report on ICFR.

Q24: Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?

49. The interaction between the communication of critical audit matters and emphasis paragraphs is clear, appropriate and aligned with the IAASB's approach. Auditors are not expected to include an emphasis paragraph about a matter that meets the definition of a CAM.

Q25: Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?

50. The re-proposed requirements for a specific order of certain sections in the auditor's report and for section titles will make the report easier to use and is broadly aligned with the IAASB's requirements.

Q26: Are the reproposed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?

51. The re-proposed amendments relating to the interaction between CAM and qualified and adverse opinions are generally aligned with IAASB requirements except in respect of adverse opinions. However, the number of these issued is small.

Q27: How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?

52. We note in our major points above our belief in the importance of the new regime not being seen as an end in itself, and that it does in fact serve as the start of a journey, opening up a dialogue between auditors, audit committees, investors and boards by providing a starting point for a discussion. The formal evidence aside, anecdotal evidence tells us that:

- it takes time for the dialogue to open up;
- many investors are 'quietly satisfied' with the new regime, the information they had so long called for is now being provided.

53. The mischief that the new auditor reporting regime was intended to remedy, which is a lack of communication has, to some extent, melted away. Our overall impression is that the enhanced reporting regime has, to date, not just worked well in the UK, but better than expected. We hope that this success will be replicated elsewhere and we hope that it will be just as effective in the US, despite the more litigious environment.

54. We note in our answer to question 1,above belief that the IMA awards in the UK which recognise excellence in auditor reporting are one way of encouraging stakeholders to engage with auditors and auditor reporting, and that the PCAOB has a role in promoting this type of engagement to investors.

Q28: How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?

55. We believe that the auditor's response, findings and key observations are likely to be of most interest to investors. Investors are generally looking for more explanation of changes.

Q29: Would critical audit matters be useful in assessing company financial performance? If so, how?

56. This question is likely to be addressed in due course by academics, however, we believe that the PCAOB should exercise caution in blurring the boundaries between companies and their auditors. Poor quality financial statements are harder to audit than good quality financial statements but the relationship between audit quality and company financial performance is likely to be complex, and good quality evidence regarding that relationship is only likely to become available a decade or more of reporting under the new regime.

Q30: Would critical audit matters be useful in assessing audit quality? If so, how?

57. Assessing audit quality, as the PCAOB is aware, is a vexed issue as evidenced by the wide variety of approaches to audit quality indicators (AQIs) currently being proposed. Nevertheless,

the disclosure of CAM seems likely to result in more focus on CAM and to encourage more extensive dialogue and to that extent, it seems likely to promote audit quality. Poorly drafted CAM will clearly impact the indirect assessment of audit quality. In our response to the IAASB's recent ITC, we went further and suggested that enhanced auditor reporting can do more than just help to *assess* audit quality. It can also contribute to the *improvement* of audit quality through its indirect demonstration of professional scepticism and transparency.

Q31: Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?

Q32: Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?

Q33: Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?

58. It seems obvious to those outside the profession that communication of CAM cannot fail to enhance attention by auditors, audit committees, and management to the matters identified as CAM and that the idea that there will be no impact on the work performed, naive. It is to be hoped that such changes will enhance audit quality, improve management's disclosures, and thereby benefit investors, but this is not guaranteed. Improvements in audit quality require a belief in the value of transparency, and that companies and firms will be rewarded for it. There are fears in some jurisdictions that the financial markets might penalise companies whose auditors go the extra mile and regulators such as the PCAOB and the SEC have an important role to play in ensuring that the financial markets properly understand the purpose and value of the enhanced auditor reporting regime.

Q34: Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?

59. The PCAOB notes that communication of CAM is a way in which firms have sought to differentiate themselves in the UK. It is important to remember in that context though that mandatory auditor rotation was also introduced in the UK at the time the new reporting regime was implemented, which seems likely to have added impetus.

Q35: Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

60. We are not aware of any such studies or data.

Q36: Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?

61. The PCAOB notes that the zero change in audit fees in the UK would not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms chose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting. This caveat is important. Underestimating the significance of the cost of regulatory reform, particularly for smaller companies and their auditors, is all too easy. The structures firm need in place to deal with these reporting requirements is such that enhanced reporting for just a few clients is likely to be particularly burdensome for smaller firms, some of which are likely to decide that it is too risky or expensive to operate in this market. This regrettable (but probably unavoidable) effect can be reduced if regulators inspect the new regime in a proportionate manner.

62. We have not responded to questions 37 - 43 as they arise from PCAOB inspections and/or is specific to the US.

Q37: Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?

Q38: For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?

Q39: While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?

Q40: Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies? Why or why not?

Q41: Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? Should the reproposed requirements be modified to make their application to EGCs more appropriate? Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?

Q42: If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?

Q43: Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?

Q44: If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? If so, what criterion should the Board use to classify companies, for example smaller reporting companies? Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?

63. We noted in our previous response that there may be some merit in phasing in the requirements, firstly for large accelerated filers whose auditors have more resources to address the new requirements to help establish best practice, and then for all other issuers.