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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
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Re: PCAOB Rulemaking Docket Matter No. 034

Dear Members and Staff of the PCAOB,

I welcome the opportunity to comment on the Board's Proposing Release No. 2016-003 regarding the standard form audit report (Docket Matter No. 034). The topic is vitally important to the quality of auditing and the utility of financial reporting. In my view, it is the most important standard setting initiative the Board has undertaken.

My views of the subject arise from a career of legal and executive responsibility for varied aspects of financial reporting and auditing, including 23 years as global Chief Legal Officer of major accounting networks and 15 years as Chairman or C-suite officer of the principal insurers of accountancy, legal practice and corporate directors. I was an active participant in the Cohen, Treadway and early COSO commissions, and in the counterpart initiatives conducted in Europe from 1990 to 2010. I was a member of ACAP and currently serve on the PCAOB Standing Advisory Group. The views I express are my own, free of constituency influence or known bias.

A brief look back is needed to see the importance of the Board's proposal in the context of capital market conditions and policy debates. The US capital markets, and financial reporting by US companies, were relatively calm and orderly following World War II, until storms of financial fraud and the emergence of class actions put legal liability into the forefront of driving factors. Those events of fifty years ago shook confidence in the capital markets, triggered the formation of what has become the FASB, launched SEC enforcement actions as the de facto audit regulator and introduced securities liability litigation as a strategic force in investment management and regulatory policy.

The turmoil of the time was addressed collegially (as measured by current conditions) through the public-private collaborations of the Cohen and Treadway Commissions of the 1970s and 1980s. The Cohen Commission Report was admirably comprehensive and perceptive, articulating the fact that liability litigation was the new elephant in the marketplace and endorsing auditing as the principle resource for taming it. The

report identified fraud as the central regulatory challenge and anointed “the expectations gap” as the most difficult reporting and auditing challenge. Under the heading REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE the Cohen report framed the issues, identified the challenges and outlined the regulatory options that have guided securities law and regulation since 1977.

We are forty years on, however, and still seeking the fix for the expectations gap and the keys to sustainable market stability. Fraud is still the driver of trouble, and audit is still the best tool in the kit. But, despite admirable efforts that have added disciplines to financial reporting and improved audit quality, the underlying challenges remain while the collegiality of the effort and the quality of discourse has deteriorated. Those were the realities that prompted Treasury Secretary Paulson to convene the Advisory Committee on the Audit Profession (ACAP) as the most ambitious and collaborative search for solutions yet undertaken.

ACAP’s 2008 Final Report made many valuable contributions on important aspects of audit capabilities and regulatory objectives. But with regard to the vexing issues of the expectations gap and audit liability it was only partly successful. The Committee gathered the deepest resource of public and non-public information ever assembled about liability conditions and consequences. But its intense deliberations over the appropriate professional and regulatory responses produced a passionate division that could not be bridged within the Committee’s mandate and timetable. Consequently, ACAP recommended by consensus that the PCAOB take over the effort. Its report provided a carefully detailed roadmap of the agreements and the conflicting conclusions it had reached.

Release No. 2016-003, and the PCAOB’s initial proposal of 2013, is the first PCAOB initiative to date that deals with ACAP recommendations concerning audit capabilities and liability as a regulatory issue. It is thus an important step directly on the subject, and of broader consequence because several pending audit standard setting proposals take a position on the effect of litigation without having studied its properties.

The Release declares that the Board is responding to the ACAP Recommendation, and also to the Cohen and Treadway reports. It suggests that the Proposal is directly and fully responsive to ACAP, whose position the Board describes as follows:

“ACAP recommended that the PCAOB consider improvements to the auditor’s report, noting that the increasing complexity of global business operations compels a growing use of judgments and estimates, including those related to fair value measurements, and also contributes to greater complexity in global financial reporting.” (Release No. 2016-003, at page 6)

While that is the head note of Recommendation 5, the essence of the Recommendation and ACAP’s reasoning are summarized at the conclusion of that section of the report:

“The Committee therefore recommends that the PCAOB address these issues, both long-debated and increasingly important given the use of judgments and 2. estimates, by undertaking a standard setting initiative to consider improvements to the auditor’s reporting model. With regards to this initiative, the PCAOB should consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal and foreign regulators. In view of the desirability of improving the quality of financial reporting and auditing on a global basis, the PCAOB should also consider the developments in foreign jurisdictions that improve the quality and content of the auditors report and should consult with international regulatory bodies as appropriate. **The PCAOB should also take cognizance of the proposal’s potential legal ramifications, if any, to the auditors.**

“Commentary has also suggested that the auditors must more effectively communicate their responsibility regarding fraud detection with investors and capital markets. The Committee agrees with this suggestion. Accordingly, the Committee believes that the auditor’s role and limitations in detecting fraud. The Committee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in finding and reporting fraud would help narrow the “expectations gap.”

“In addition, the Committee recommends that the PCAOB and the SEC clarify in the auditor’s report the auditor’s role and limitations in detecting fraud under current auditing standards. **In addition, the Committee recommends, in light of the continuing “expectations gap,” that the PCAOB review the auditing standards governing fraud detection and fraud reporting. Specifically, the Committee recommends that the PCAOB periodically review and update these standards.**” (ACAP Final Report, at pp VII:17-18. Emphasis added)

I am dismayed by the narrow scope of the PCAOB’s uptake of the ACAP recommendation. In 2011 the Board announced that it planned to initiate, in the near future, the collaborative fraud study recommended by ACAP. By 2013 that intention had been transformed into a plan to have the Board and staff perform the study without external participation. For the past three years there has been no sign of a continuing intention to do so. It appears that the Proposal for modification of the auditors reporting model is the extent of the Board’s intended response to the ACAP Recommendation 5.

The need for attention to financial fraud, expectations gaps and liability consequences has not declined since the ACAP report. On the contrary, the data and analytic competencies that have emerged since 2008 have enabled a new landscape of audit initiatives that deserve more rather than less thoughtful regulatory attention.

Release 2016-003 proposes one fraud related change to the wording of the auditor's standard form report. Existing standards require assurance that the examined financial statements are free of material misstatement. The Board proposes that this should be clarified by noting that the assurance applies whether material misrepresentation might have been "caused by error or fraud."

As a change of wording, but not of meaning, that must surely be appropriate. But it does not address the fundamental issues raised by Cohen and Treadway of the need to clarify what can be professionally and legally expected of auditors in relation to collusive financial fraud, nor does it attempt to deal with the expectations gap and liability consequences that were of central concern to ACAP.

Nevertheless, the proposal to add "error or fraud" generated considerable attention when it first appeared in 2013. Under the heading "Liability Considerations Related to Critical Audit Matters," Release 2016-003 provides a summary of the comments received that were concerned with the potential for adverse liability consequences of the proposed change, the five paragraphs of which begin as follows:

"The potential for increased auditor liability was cited as a concern by a number of commentators..."

"Some commenters raised more specific liability concerns about critical audit matters..."

"Other commenters claimed that the fact-specific nature of critical audit matters or of certain potential elements of the description of critical audit matters, such as the audit procedures used, would make it difficult to obtain early dismissal of claims..."

"Several commenters highlighted the proposed requirement to document the auditor's determination that a matter was not a critical audit matter as increasing litigation risk with respect to such matters..."

"Some commenters argued that critical audit matters could also increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, and plaintiffs may attempt to use critical audit matters as a "road map" for litigation against the company." (Release, pages 40-42. The number of concerned commenters was not disclosed.)

By contrast, the entirety of opposing views is described this way:

"On the other hand, one commenter asserted that communicating critical audit matters conceptually could decrease auditor and company legal exposure when the accounting in the areas of the critical audit matters is

subsequently challenged, because the communication of critical audit matters is about disclosure of risks and challenges. The commenter further stated that the communication of such matters would be more problematic from a litigation point of view.”

The meaning of that comment is less than self-evident. But it does seem clear that it was the sole voice of attempted comfort.

The Release concludes that the liability commentaries did not constitute a reason to reconsider “whether through error or fraud” was appropriate because the Board had modified the proposed CAM terms of implementation. The proposal does not explain how this conclusion was reached, nor does it attempt to address the core question of fraud and its impact on auditing.

ACAP developed a comprehensive platform of information and opinions on these issues, the most extensive and candid effort to date and one not easily recreated. It is a ready resource and starting point for the PCAOB to assess audit liability risks and their public interest consequences. Despite its deep divisions of opinion, the members of ACAP (with a single dissent) agreed on much of the factual underpinnings of the liability debate, specifically including the following:

- At the 2008 report date, the six largest US audit firms were defending a combined total of 90 malpractice suits seeking in excess of \$100 million. Of those, 27 claims alleged shareholder losses of more than \$1 billion and 7 claimed damages in excess of \$10 billion. Those are not fantasy inflated numbers. They are actual market loss consequences of public company restatements. ACAP recognized that any one of the 90 suits, if successful, would dwarf the firm’s capital.
- Annual liability costs (judgments, settlements and expenses net of insurance) was more than 15% of the six firm’s annual audit revenues, a proportion of income that is vastly greater than that of any other industry or profession.
- State and federal regulations in the US require auditors to function as partnerships, prohibited from raising third party capital. While limited liability partnerships protect some assets, every partner’s income, capital account and retirement benefit remain exposed to the unpredictable outcomes of liability litigation. No other form of US enterprise has such a hazardous balance of risks and rewards.
- The potential for a liability induced collapse of another major firm was a consensus worry, even to the extent that ACAP recommended that Congress enact a complex scheme for the rescue and rehabilitation of firms in jeopardy, not unlike the Dodd Frank model of bank resolutions. ACAP’s co-chairs, Arthur Levitt and Donald Nicholaisen, went the further step of recommending federalization of the audit profession. Both proposed remedies are dramatic.

These extraordinary remedies would not have been recommended without collective acceptance that audit liability risk is existential and real.

The ACAP report also articulates the differences that members could not overcome, with care to preserve the contrasting perspectives for future attention. These included:

- Whether it was likely that the unresolved issues of responsibility and liability would cause another firm to collapse, as Andersen just had.
- Whether another firm collapsed would be a stand alone event or the first leg of an implosion of the traditional large firm business model due to partner flight from within or insufficient competition to meet investor needs.
- Whether the extreme risks of audit liability inhibit advancements in audit quality, or constitute a motivator of optimal audit performance.
- What forms of liability law reform, or regulatory safe havens, would be most useful in the public interest.
- Whether expansions of the auditor's role can be responsibly contemplated without careful assessment of intended or unintended liability consequences.

Release No. 2016-003 proposes to do just that—extend auditor responsibilities—with exclusive focus on whether there might be benefits in doing so. The risks of doing so have barely been considered. The forty year search for a sound platform of how financial fraud and audit responsibility should intersect, and the parallel dilemma of how liability inducing expectation gaps can be mitigated, have been bypassed.

I urge that the proposal be withdrawn for further collective study, drawing upon the information and the strategic resources that have been prepared by ACAP and preceding studies. Only by enlarging the scope of attention can changes to the auditors reporting model emerge from core perspectives about the sustainable role of auditing in the world's most litigious society.

Respectfully submitted,

/S/

Richard H Murray

Cc: Chair Doty and Members of the Board
Chief Auditor and Director of Professional Staff