DHG
DIXON HUGHES GOODMAN LLP

4350 Congress Street, Suite 900
Charlotte, NC 28209
P 704.367.7020
F 704.367.7760
dhgllp.com

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VIA E-MAIL: comments@pcaobus.org

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 034

Dear Members of the Board and Staff:

Dixon Hughes Goodman LLP (DHG) welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) 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 Related Amendments to PCAOB Standards* (Proposed Standard). Headquartered in Charlotte, NC, DHG ranks among the top 20 public accounting firms in the nation, with more than 2,000 professionals and staff in 12 states, and is a member of Praxity, a global alliance of independent firms.

DHG is supportive of the PCAOB's efforts in modernizing the auditor's report to provide information that is of critical need to stakeholders, while maintaining the value of the 'pass-fail' opinion. We also commend the PCAOB for their significant outreach efforts in developing a balanced approach that considers the views of numerous stakeholders, as well as developments within the international markets. We believe the enhancements within the Proposed Standard generally align with those of the International Auditing and Assurance Standards Board (IAASB); in particular, the concept of Critical Audit Matters (CAM) with the IAASB's concept of Key Audit Matters.

This letter includes our views, observations, and recommendations on the Proposed Standard. Our responses are framed by our experiences serving middle-market public issuers and non-issuer brokers and dealers, and include our concerns regarding the potential implications the Proposed Standard could have for smaller to medium-sized accounting firms.

Overview

Overall, DHG is supportive of enhancing the CAM definition towards material issues discussed with the audit committee. We also support the Board's non-prescriptive approach to the auditor describing how a CAM was addressed in the audit, including providing certain elements for the auditor's consideration[1] that generally align with similar elements included within International Standard on Auditing 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (ISA 701).[2] Further, we believe the language preceding the description of the CAM clearly articulates that the communication of CAMs should not be interpreted as altering the level of assurance on any aspect of the auditor's report, including

[1] Page 31, Proposed Standard.
[2] Paragraph A46, ISA 701.

the identified CAMs. In addition, given the level of professional judgment inherent in CAMs, we believe the profession will greatly benefit from the illustrative examples depicting CAM communications.

Outside of CAMs, we are supportive of enhancing the wording of the auditor's report in relation to independence and the auditor's responsibilities regarding financial statement notes and obtaining reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. We also support moving the opinion paragraph to the beginning of the auditor's report, which more closely aligns with the auditing standards of the IAASB.

Despite these numerous enhancements, we believe there are certain areas within the Proposed Standard that could negatively affect the profession; in particular the potential litigation risk of the audit firm being the source of original (and potentially confidential) information about a company.[3] As the auditor is responsible for opining on the information that comprises the financial statements, we believe any information communicated within the auditor's report should be limited to information opined upon, and not include information that is of original (or confidential) nature. Furthermore, appreciating the Board's interest, we continue to question the value of including auditor tenure in the auditor's report. Evidence about the impact of audit tenure on audit quality continues to be inconclusive, and there is a concern that disclosing tenure could imply there is negative correlation between auditor tenure and audit quality.

We have provided certain comments and recommendations below regarding these points as well as other matters detailed within the Proposed Standard.

Source of Original Information

Determination of Potential CAMs

DHG supports limiting the source of potential CAMs to those matters communicated or required to be communicated to the audit committee, adding a materiality component that directly relates accounts and disclosures to the CAM definition, and focusing on matters that involve especially challenging, subjective, or complex auditor judgment in the audit. We believe, in totality, these enhancements would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of CAMs within the auditor's report that could deemphasize their importance. However, despite these advancements in narrowing the CAM definition, there is still risk, in certain situations, that the auditor could divulge original (and potentially confidential) information about the company, whether through the identified CAM or within the practical considerations in determining the CAM.

For instance, a significant deficiency within a company's system of internal control over financial reporting (ICFR) by itself is not a material matter to the financial statements. However, a significant deficiency is a required communication to the audit committee that typically relates to one or more accounts or disclosures that are material to the financial statements, and could meet the proposed CAM definition, if the matter involved especially challenging, subjective or complex auditor judgment. There also may be situations where accounts or disclosures, by themselves, would not likely be considered CAMs, but due to a related significant deficiency in the company's ICFR, could lead the auditor to identify these accounts

[3] For the purpose of our response, original information is information about a company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure.

or disclosures as CAMs, and therefore would require communication of the significant deficiency as a principal consideration that led to the CAM determination.

Under both scenarios, management has no similar requirement to disclose a significant deficiency under the SEC rules, and it is unclear, if such information is communicated in the auditor's report, whether this could result in a breach of client confidentiality and expose the auditor to related litigation or disciplinary action under contract and state law.[4] Regardless, we do not believe auditors should publicly communicate information, which is the responsibility of management, particularly in instances where the auditor could be at risk of potentially violating certain laws and regulation.

Communication in the Auditor's Report

In considering the potential risk of communicating original information about a company, the Proposed Standard includes a note that indicates that when describing a CAM, the auditor is not expected to provide information that has not been made publicly available. However, the same note also includes a statement that allows the auditor to provide such information if it was necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the matter was addressed in the audit.[5] Although we support the inclusion of a statement that explains the expectations of the auditor not providing original (and potentially confidential) information about a company, it is inappropriate to include a seemingly contradictive statement that allows for communication of such information in certain circumstances.

Allowing for the inclusion of original information (regardless of the situation) within the auditor's report could possibly expose the auditor to certain ethic codes and other regulatory violations, and effectively impose disclosure thresholds on management that go beyond the applicable financial reporting framework or SEC reporting requirements. Therefore, we strongly encourage the Board to consider removing this statement from Note 2 of the Proposed Standard.

Furthermore, the Board should specifically describe in the Proposed Standard that the auditor is not responsible for providing original information about the company in the auditor's report; and we recommend the Board revise Note 2 of the Proposed Standard as follows:

> "When describing critical audit matters in the auditor's report the auditor ~~is not expected to~~ **should not** provide information about the company that has not been made publically 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~~."

CAM Communication Illustrations

In considering potential challenges audit firms may face in implementing the Proposed Standard, we commend the Board for recognizing the need for application guidance by providing illustrative CAM communications examples.[6] We believe such illustrations could be a valuable resource to audit firms in guiding their expanded communications, and we strongly encourage the Board to include similar illustrations in the final standard.

[4] For instance, the Supreme Court has ruled in the past that persons cannot be held liable under Section 10(b) and Rule 10b-5 unless they actually "make" a statement (Janus Capital Group v. First Derivative Traders 131 S. Ct. 2296 - 2011).
[5] Note 2, paragraph 14, Proposed Standard.
[6] Pages 32 – 35, Proposed Standard.

In providing such guidance, however, it is important to clearly articulate the purpose of the illustrations (e.g., illustrate how the auditor may describe the principal considerations that led the auditor to determine that the matter is a CAM), how they correlate with the minimum requirements of the standards, and not imply the need for additional disclosures outside those requirements. For instance, the illustrations within the Proposed Standard appear to include context associated with management's processes[7] and strategies,[8] and audit information[9] that are beyond the scope of the auditor's communication requirements.[10] We believe this is inconsistent with the Board's intention of providing a non-prescriptive approach to describing how a CAM was addressed in the audit,[11] and we encourage the PCAOB to revise the illustrations to correlate with, and limit any suggested disclosures outside of, the auditor's communication requirements.

Legal Liability Implications

The advancements made within the Proposed Standard, in particular narrowing CAMs to matters communicated to the audit committee and incorporating the concept of materiality, mitigates the increased legal liability associated with expanding auditor reporting, as compared to past proposals.[12] However, despite these advancements, there is still an increased level of litigation risk under both federal and state law, particularly in disclosing original (and potentially confidential) client information. We believe our recommendations above provide a basis for diminishing these concerns and strongly encourage the Board to consider these revisions within the final standard.

Additional Considerations in Determining CAMs

Appreciating the Board's efforts to limit the potential number of CAMs as compared to prior proposals, we believe determining whether a matter is a CAM will still require significant auditor judgment. The Proposed Standard provides additional guidance in the form of factors auditors should take into account in determining whether a matter involves especially challenging, subjective, or complex auditor judgment.[13]

Although we support the inclusion of these factors, we believe there are opportunities to clarify the linkage of procedures performed by the auditor and sufficient appropriate audit evidence obtained in performing those procedures. For instance, in considering the degree of auditor subjectivity in paragraph 12b of the Proposed Standard, we believe the auditor should focus on procedures executed to obtain sufficient and appropriate audit evidence related to the matter under consideration, as opposed to focusing on overall audit strategy decisions in designing audit procedures to obtain sufficient appropriate evidence. Therefore, we recommend removing 'determining' from paragraph 12b of the Proposed Standard, and focus the auditor on procedures applied to address the matter under consideration or in evaluating the results of those procedures.

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[7] For instance, details on management's processes in developing the loss rate within the *Allowance for Loan Losses* illustration (Pages 32 – 33, Proposed Standard).
[8] For instance, details related to management's strategies included within the *Accounting for Acquisition* illustration (Pages 33 – 35, Proposed Standard).
[9] For instance, details related to testing of the company's system of internal control over financial reporting within both illustrations (Pages 32 – 35, Proposed Standard).
[10] Paragraphs 13 and 14, Proposed Standard.
[11] Page 31, Proposed Standard.
[12] See PCAOB Rulemaking Docket Matter No. 34: Release No. 2011-003 – Concept Release, Release No. 2013-005 – Proposed Rule.
[13] Paragraph 12, Proposed Standard.

Additionally, paragraph 12f of the Proposed Standard focuses on the 'nature of audit evidence,' which is a component in obtaining sufficient appropriate audit evidence. However, paragraph 12c of the Proposed Standard references to the 'nature and extent of audit effort required in addressing the matter,' which may also have a general correlation to sufficient appropriate audit evidence.

To limit any potential application concerns, we encourage the PCAOB to link the factors within paragraph 12 to PCAOB Auditing Standard No 15, *Audit Evidence*, which explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence. This could be accomplished by removing paragraph 12f and revising paragraph 12c, to provide enhanced linkage between the nature and extent of audit effort to sufficient appropriate audit evidence obtained.

Auditor Tenure

Appreciating the Board's efforts in this area, DHG does not support inclusion in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor (i.e., audit firm tenure). There is no empirical evidence supporting a correlation between audit tenure and audit quality, and the inclusion of such information in the auditor's report could imply such a correlation exists. If the PCAOB continues to believe this information is of relevance, as audit committees are responsible for the oversight of external auditors, they may be in the best position to consider providing this information.

The Securities and Exchange Commission (SEC) issued a concept release[14] seeking stakeholder input on potential enhancements to disclosures for audit committees, specifically requesting comment on a number of possible changes to existing SEC disclosure requirements regarding the audit committee's oversight of the external auditor, including information about the length of the audit relationship in the audit committee's report. Therefore, we encourage the PCAOB, in considering a potential alternative location, to collaborate with the SEC to determine whether audit committees should consider disclosing this information within the proxy statement or the audit committee report.

Effective Date Considerations

In considering an appropriate effective date, careful consideration should be given to the anticipated costs and efforts expected to be incurred by audit firms in ensuring appropriate processes are in place to comply with the Proposed Standard. For instance, audit firms would need to develop quality control processes and staff training programs to ensure auditors are appropriately identifying and documenting the consideration of CAMs. We would also anticipate substantially expanded communications between auditors, preparers and audit committees, particularly in evaluating the potential effect of the additional auditor communications in the auditor's report.

We believe that these extensive implementation efforts could place a significant and possibly disproportionate burden on smaller and medium-size accounting firms (and their clients). Therefore, in considering an effective date that provides an ample implementation period for audit firms of all sizes, while providing timely, reliable information to financial statement users, we strongly encourage the Board to consider a phased-in implementation approach, as follows:

- Phase 1 – Applicable to large accelerated filers for audit periods ending at least two years subsequent to the SEC's approval of the final rule.

[14] See Concept Release No. 33-9862, Possible Revisions to Audit Committee Disclosures.

- Phase 2 – Applicable to accelerated and non-accelerated filers one year after the Phase 1 effective date.

We believe such an approach would also allow the Board, possibly through its Post-Implementation Review Process, to evaluate whether the Proposed Standard is accomplishing its intended purpose. As part of this evaluation, the PCAOB should solicit feedback from stakeholders (e.g., preparers, investors, audit committees) to identify, wherever possible, costs and benefits, and potential unanticipated consequences associated with the Proposed Standard.

Applicability

DHG is supportive of not requiring the identification, communication, and documentation of CAMs in the auditor's report for non-issuer brokers and dealers, investment companies (that are not business development companies), and employee benefit plans (i.e., employee stock purchase, savings, and similar plans). However, we believe the requirements of the Proposed Standard, in its entirety, should apply to audits of emerging growth companies, as they exhibit characteristics similar to other public companies and financial statement users would benefit from similar reporting requirements.

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DHG is supportive of providing financial statement users additional transparency into the audit and believes the Proposed Standard provides a general basis for expanding auditor disclosure. We appreciate the opportunity to comment on the Proposed Standard and are pleased to discuss any questions the Board and its Staff may have concerning our comments. Please direct any questions to Dave Hinshaw, Managing Partner, Professional Standards Group (dave.hinshaw@dhgllp.com) and Jeffrey Rapaglia, Partner, Professional Standards Group (jeff.rapaglia@dhgllp.com).

Sincerely,

Dixon Hughes Goodman LLP

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