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October 14, 2011

Mr. Martin F. Baumann, Chief Auditor
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006

Re: PCAOB Release No. 2011-003; Rulemaking Docket Matter No. 034;
Possible Revisions to PCAOB Standards Related to Reports on Audited
Financial Statements and Related Amendments to PCAOB Standards

Dear Mr. Baumann:

In Release No. 2011-003 (the "Release"), the Public Company Accounting Oversight Board (the "Board" or "PCAOB") solicited public comment on the potential direction of a proposed standard-setting project on the content and form of reports on audited financial statements. We compliment the Board on its outreach in connection with the preparation of the Release and urge it to continue its efforts to make the financial statements and the auditor's report more transparent and relevant to investors. We welcome the opportunity to comment on the Release and on this important issue.

I. Introduction

Our perspective in considering the auditor's report is informed by our role as legal advisers that represent issuers and others in connection with a wide variety of matters that are intimately involved with the financial reporting process. Among those matters are the following:

- We advise issuers in the preparation of their disclosure, including, in particular, financial reporting, during which we work closely with management, audit committees and auditors.

- We advise issuers and underwriters in a wide variety of capital markets transactions for which financial reporting is a critical element.

- We advise issuers, investors, acquirors and other participants in a wide variety of corporate transactions, including mergers and acquisitions, in which financial reporting is also critical.

- The transactions in which we participate (both capital markets and corporate) include public transactions involving disclosure to a broad range of investors and private transactions involving sophisticated institutional investors.

In all of these contexts, we are dedicated to the full and fair disclosure – and in particular financial disclosure and reporting – called for by the federal securities laws, transparency to investors and markets, and the improvements in financial disclosure and reporting that are fostered by the application of robust auditing standards by independent external auditors.

The Release correctly acknowledges the investment community's concern that auditors might have information useful to investors and other financial statement users that is not communicated under the existing pass-fail model of the auditor's report. While we think some modifications to the auditor's report may be desirable, we believe the Board should keep four principles in mind as it considers any changes to the auditor's report.

First, any change to the auditor's role or report must have a significant probability of improving the financial reporting process and its results. Most of the alternatives discussed in the Release relate to providing investors more information about the audit process and the decisions of management, the audit committee and the auditors in connection with the audit and financial statements. Such disclosure only provides benefits if it in fact improves the quality of financial reporting. For example, the Release suggests consideration of whether to propose an Auditor Discussion & Analysis ("AD&A") where, among other topics, auditors would provide discussion of alternative accounting treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management. We do not think a discussion of alternative accounting treatments necessarily improves investors' understanding of an issuer's financial statements, because it risks burdening investors with too much information that may obscure what is truly important. If the treatment adopted and disclosed by management conforms to generally accepted accounting principles ("GAAP"), then, by definition, such treatment is acceptable accounting and, under the standard of the auditor's report, must fairly present the issuer's financial position. Further, a voluntary change to applicable accounting principles generally requires the issuer to conclude, and the auditor to agree, that application of the new principle is preferable.

Second, if there is additional information regarding an issuer that should be disclosed, that disclosure should be the responsibility of, and should come from, the issuer and not the auditor or any other third party. As noted in the Treadway Commission's 1987 report,

> the responsibility for reliable financial reporting resides first and foremost at the corporate level. . . . Independent public accountants play a crucial, but secondary role. They are not guarantors of the accuracy or the reliability of financial statements. . . . [M]anagement's primary responsibility for reliable financial reporting should be emphasized, so that public understanding of the relative and complementary obligations of corporate management and independent public accountants is improved.[1]

While the Release notes that as a result of the performance of audit procedures, auditors have significant information regarding a company's financial statements, it is nonetheless the case that management has the best insight into the financial statements and financial condition of a company and has the greatest ability to make judgments about market conditions, risks and other factors that might be relevant to the future performance of a company. If the Board believes additional financial disclosure is useful to investors, efforts should be made with the Securities and Exchange Commission (the "Commission") to address such concerns, which we believe are beyond the scope of the auditor's report.

As an illustration of this principle, continuing with the example discussed above, if one were to conclude that it is sufficiently beneficial to include additional information about alternative accounting treatments in an issuer's disclosure document (a conclusion as to which we are skeptical), the issuer and not the auditor should be responsible for providing that disclosure. Issuers – not auditors – are responsible for what accounting principles are applied and should be responsible for explaining those choices if an explanation is necessary. Under current auditing standards, the auditors would be required to read that disclosure and determine that it is not in conflict with the financial statements (including the Significant Accounting Policies Note). This is consistent with the primary and secondary roles of the company and its auditors, respectively, in connection with financial reporting.

Third, any change to the auditor's reporting model should not alter the relationship and the structure of interactions among management, the audit committee and auditors as they have developed since the enactment of the Sarbanes-Oxley Act of 2002 and the related implementation of regulations and standards adopted by the Commission and the PCAOB ("Sarbanes-Oxley"). In our view, based on considerable personal observation of both the processes of these interactions and the results, the Sarbanes-Oxley reforms have significantly enhanced the financial reporting system and the quality and reliability of financial reporting by

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[1] *See* National Commission on Fraudulent Financial Reporting, Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987).

empowering audit committees and mandating communication among management, the audit committee and auditors in ways that have expanded the discussion well beyond the mandated matters and have in other respects enhanced the audit process. We think the regular and free-flowing dialogue of auditors with management and the audit committee, as well as the robust application of GAAP and generally accepted auditing standards, have resulted in better and more reliable financial disclosure to investors. The reforms also paved the way for additional opportunity and leverage for auditors to influence the financial statements (one of the potential benefits cited for the AD&A proposal discussed in the Release). Based on our direct experience, we are concerned that requiring auditors to make public disclosure about issuers would have a chilling effect on communications among management, audit committees and auditors. If management and audit committees believe auditors will be required to make communications public, they may be reluctant to engage in the honest and open dialogue encouraged by Sarbanes-Oxley that has resulted in more robust financial disclosure. In our view, such a development carries with it a serious risk that the quality of the overall audit process would decline and with it the quality and reliability of financial reporting. The Board should therefore evaluate proposals based on whether they are likely to encourage or discourage open dialogue among management, audit committees and auditors.

Fourth, the benefits of any path pursued by the PCAOB should of course outweigh the costs. We do not believe the purpose of cost-benefit analysis should be to stifle appropriate regulation. Rather, it is a widely held view that our current disclosure system, accounting principles and auditing standards are overly complicated and burdensome. High quality, reliable financial reporting is pressured by market and regulatory demand for timely information. In this environment, there are genuine benefits to focusing on narrow and incremental changes that have the greatest likelihood of improving disclosure and providing investors better information in a cost effective manner. Moreover, while the costs that should be considered include monetary costs, burdens on management and auditors, and increased length and complexity of financial statements and other financial disclosure, there are others, some of which are noted above. In particular, the risk of reducing the quality of both the financial statements and the internal control audit posed by adversely affecting the steadily improving structure of relations among auditors, audit committees and management is in our view an unacceptable cost. Moreover, we are concerned that many of the alternatives suggested in the Release to expand the role of the auditor or the breadth of the auditor's report will impose costs without accompanying benefits, because they will take time and money to implement but may merely lead to additional boilerplate language that provides little additional information.

Finally, in considering changes to the auditor's report, we should not undervalue the current audit process and the significance of the report under the pass-fail model. The pass-fail determination has value for investors because it clearly reflects that an audit has taken place under the current robust standards and provides reasonable assurance that the issuer has both financial statements in accordance with GAAP and internal controls that, except as disclosed, do not suffer from material weaknesses. Other information surrounding the audit may be useful, but we believe nothing about the audit process is as important to investors and markets as making the audit process (and the resulting pass-fail conclusions) as reliable as possible. In our professional

judgment, a robust pass-fail auditing system contributes significantly to the accuracy and reliability of financial statements.

II. Auditor's Discussion and Analysis ("AD&A")

An AD&A of the sort described in the Release would be inconsistent with the principles described above. Our primary concern is that AD&A asks auditors to provide disclosure that is the responsibility of the issuer. Not only are issuers appropriately responsible for disclosure about themselves, but they also are in a better position than auditors to reach conclusions about their financial reporting and craft disclosure even as to financial matters. And issuers are certainly in a better position than auditors to draft disclosure regarding other, non-financial matters. If investors perceive shortcomings in issuer disclosure, those gaps arise in the application of GAAP, the Commission's disclosure rules and guidance or the reporting practices of issuers. We do not think changing the role of the auditor, adding auditor-authored sections to disclosure documents or altering the auditor's report is the best way to address concerns regarding the need for additional or enhanced financial disclosure. Rather a discussion of such concerns should include the Commission and the PCAOB in a broader dialogue with issuers and other market participants.

We understand that some investors believe auditors can provide insight into an issuer's financial statements due to the auditors' independence or familiarity with industry participants other than the issuer in question. The fact that auditors are independent, however, does not address whether they should provide disclosure regarding the issuer. The Commission's independence standards under Rule 2-01 of Regulation S-X speak to whether an auditor is objective in carrying out its audit of an issuer's financial information. We do not believe independence is probative of an auditor's ability to analyze or provide disclosure regarding an issuer or industry or supplant the judgments of an issuer. Any proposals should be careful not to confuse independence with expertise in crafting better disclosure.

We also believe the premise that industry familiarity provides auditors with an advantage that allows them to provide significantly better disclosure than issuers should be closely examined. In our experience, management is generally very familiar with industry practices. While industry familiarity can provide auditors an experience base for the current discussions that go on between auditors and management, it is difficult to see how it would translate into better disclosure. As a matter of professional confidentiality, an auditor will not be able to disclose that client Company A follows more or less preferable accounting than client Company B (or C or D). Instead, we believe internal discussions among management, audit committees and auditors regarding industry practice are more likely to lead to better financial reporting than disclosure regarding industry practice in a specified area of accounting.

Another issue with AD&A is that the proposed topics for disclosure may be of limited use to investors. For instance, the illustrative AD&A included in the Release suggests that auditors would provide discussion of difficult or contentious issues or "close calls" that arose during the audit and the final resolution of such issues, such as accounting matters that required significant deliberation by the auditor and management before being deemed acceptable

within the applicable financial reporting framework. In our experience, when we focus on difficult financial disclosure questions with issuers, a matter often requires significant deliberation because it is extraordinarily important to the financial statements or is in an area where it is difficult to apply accounting principles because, for example, of the subjective judgments and estimates required. Put another way, as a general matter, extensive focus and deliberation may not be indicative of an issuer trying to "push the envelope" in application of accounting principles. The fact that the parties carefully thought about an issue for an extended period of time does not necessarily mean investors gain greater clarity into the company's financial statements from disclosure of those discussions. On the other hand, if the focus on difficult questions in the application of accounting principles or the use of accounting estimates is intended to illuminate the most important and challenging accounting judgments reflected in a company's financial reporting, we believe this is an area where, as further discussed below, disclosure enhancements can productively be considered.

The Board should also consider the effect AD&A would have on the Sarbanes-Oxley reporting framework. Any requirement that auditors make substantive public disclosures about the issuer will adversely affect the audit process, and the related corporate governance process, by inhibiting candid discussion and exchange among management, the audit committee and the auditor. Furthermore, the Sarbanes-Oxley reforms included measures, such as the CEO and CFO certifications as to disclosure and internal controls and the auditor's report on the effectiveness of internal control over financial reporting, to address concerns over the reporting process. The financial reporting process and related corporate governance have improved in the wake of Sarbanes-Oxley, and as discussed above, we fear this "chilling" effect carries with it a significant risk of adversely affecting the quality of audits and the accuracy and reliability of financial reporting.

A final concern we have with AD&A as proposed is our strong belief that it will devolve into boilerplate. Issuers and auditors alike fear that increased disclosure will lead to increased liability. There is a high degree of probability that AD&A will result in standardized disclosure and not meaningful company-specific individualized disclosure. Individualized disclosure will continue to be left to issuers. To the extent disclosure enhancements would be beneficial, issuer disclosure under the Commission's rules should be the focus.

III. Modifications to the Auditor's Report

A. Critical Accounting Policies and Estimates

At the September 15, 2011 Roundtable, during the discussion of AD&A, the possibility was raised of considering an important but more narrowly focused report on critical accounting policies and estimates, where additional attention by issuers and additional involvement by auditors would be both beneficial to investors and cost effective. While we do not believe a targeted discussion of critical accounting policies and estimates is appropriate within the broad rubric of AD&A (with the defects inherent in that approach described above), we do believe consideration should be given to focused auditing standard-setting on critical accounting policies and estimates. This area is ripe for auditor review because, as investors

indicated in the Board's outreach effort, there remains a need for better disclosure of the impact of estimates and judgments by issuers. As noted in the Release:

> [s]ince reasonable estimates might vary significantly, there could be a wide range of acceptable results within a company's applicable financial reporting framework. Further, this range of acceptability is not mentioned in the auditor's report and might not be fully reflected in the financial statements.[2]

We believe, in connection with the PCAOB considering a new auditing standard, it would be valuable for the Commission to provide further guidance with respect to critical accounting policies and estimates disclosure. After two releases discussing critical accounting policies in December 2001 and January 2002, the Commission issued proposed rules on critical accounting policies in May 2002.[3] The Commission did not complete the process of a formal rulemaking. Instead it offered guidance on critical accounting policy disclosure in its December 2003 interpretive release on Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").[4] If auditors are to assist in a process of improving disclosure to investors, the Commission should consider whether it would be beneficial to consolidate the existing disclosure guidelines and give further guidance through additional formal rulemaking. In our view, it is important that any new guidance not provide for increased disclosure (in what are already overly lengthy disclosure documents) but rather improved disclosure. Ideally, the Commission guidance would focus on the methods for determining critical accounting policies and estimates and appropriate disclosure of such policies to investors, including uncertainties inherent in the estimation process and the impact of estimates on financial statements.

A new auditing standard, which we think would be best crafted through the joint efforts of the Commission and the PCAOB, could create a narrowly enhanced role for auditors to review an issuer's disclosure of critical accounting policies and estimates in MD&A to confirm whether it is consistent with the Commission's disclosure requirements. In an unqualified auditor's report, then, the auditor could attest to the issuer's compliance with requirements for the fair presentation of its critical accounting policies and estimates. We think in the narrowly focused context of critical accounting policies and estimates, the adoption of an auditor review standard could both improve issuer disclosure in MD&A and be beneficial to investors' understanding of such disclosure. The auditor's statement of compliance could also include an opportunity for the auditor, at its discretion, to emphasize matters within critical accounting policies and estimates that the auditor thinks worth highlighting, similar to the emphasis

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[2] PCAOB Release No. 2011-03 (Jun. 2011) at 6.

[3] SEC Release Nos. 33-8040; 34-45149; FR-60 (Dec. 2001). SEC Release Nos. 33-8056; 34-45321; FR-61(Jan. 2002). SEC Release Nos. 33-8098; 34-45907; International Series Release No. 1258 File No. S7-16-02 (May 2002).

[4] SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

paragraph framework. For the reasons we describe below, we do not think auditor review of all of MD&A would improve disclosure or be beneficial to investors.

As discussed above, instead of styling a new standard in an AD&A format as discussed at the September 15, 2011 Roundtable, we believe an auditor attestation with respect to critical accounting policies and estimates should be included in the auditor's report. This focused review and report is not dissimilar to the auditor's review and report on internal control over financial reporting, but we think this proposal fits more squarely within the existing auditor's report framework rather than calling for a separate auditor report.

B. Clarification of the Standard Auditor's Report

Clarifying the language in the standard auditor's report may be worth pursuing. If investors do not understand the auditor's role in providing reasonable assurance on the accuracy of the issuer's financial statements or that auditors are not guarantors against fraud, there is indeed an expectation gap between what investors expect and the reality of what an audit provides. Participants in the disclosure and financial reporting process, including auditors, should think of ways to provide investors with better information about what auditors are, and are not, responsible for and what they do and do not do. Additional explanation and clarification within the auditor's report may be a reasonable way to address this issue and can be introduced without changing the basic reporting framework.[5]

We wonder, however, if additional explanation in the auditor's report is the best way to addresses this expectation gap. Placing the same boilerplate in every auditor's report for thousands of issuers every year may not be the most efficient or effective way to educate investors about the auditor's role in the financial reporting process. Placing that information on the websites of the Commission, the PCAOB and audit firms may be a better solution than altering the auditor's report. However the Board proceeds, it should do so in the most cost effective and efficient way possible, mindful that the benefits must outweigh the costs.

C. Required and Expanded Use of Emphasis Paragraphs

Before mandating an expanded use of emphasis paragraphs, we believe it would be useful for the Board to reexamine the current framework surrounding such paragraphs. Under AU Section 508.19, auditors may, at their discretion, emphasize a matter regarding the financial statements. That said, as discussed at the September 15, 2011 Roundtable, auditors almost never

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[5] As noted in the AICPA's clarifying Statement on Auditing Standards "Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report" (the "Clarifying SAS"), "Other Matter" paragraphs in the auditor's report can be used to provide explanation "relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report." *See* AICPA, *Statement on Auditing Standards: Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (2010), available at: http://www.aicpa.org/Research/Standards/AuditAttest/ASB/DownloadableDocuments/Clarified_SAS_EOM_OM.pdf at §5.

use emphasis paragraphs. In our opinion, this lack of use may point more to an issue of implementation of the current standard than to a need for new standard setting.

As noted in the AICPA's Clarifying SAS "Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report," emphasis paragraphs should be used

> [i]f the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to user's understanding of the financial statements . . . .[6]

We believe it may be helpful for the Board, as part of its regular inspection of auditor's reports, to consider where emphasis paragraphs could have been used and then to provide additional guidance to auditors to encourage the inclusion of emphasis paragraphs where useful.

If the Board determines instead to move forward with consideration of a proposal to mandate emphasis paragraphs, we believe the Board should consider two concerns. First, if not carefully constructed, the mandatory emphasis paragraphs will likely devolve into additional boilerplate, which would not provide the desired insight to investors. Second, any proposal for mandated emphasis paragraphs must also include clear, objective standards for auditors to follow in determining how and when to include those paragraphs.

IV. Auditor Review of Other Information Outside the Financial Statements

A. MD&A

In our view, requiring auditors to comment on information outside the financial statements, in particular on MD&A, is inconsistent with the auditor's role and core expertise. Auditor expertise centers on financial information, financial reporting, auditing and related matters and does not extend to evaluating business strategy and trends, analyzing risk (except for risks regarding financial reporting) or predicting future performance. The purpose of MD&A should be considered against this backdrop. The Commission has made it clear on several occasions that the principal value of well-crafted MD&A is that it provides information about the issuer through management's eyes, gives a sense of the overall context within which financial information should be analyzed and provides relevant information to investors about the issuer's past and future performance.[7] Good MD&A disclosure contains information with regard to the

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[6] *Id.* at §6.

[7] *See* SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

quality of earnings and known trends and uncertainties.[8] The Commission has also made clear that good MD&A should not consist merely of the regurgitation of information in the financial statements but should focus on analysis.[9] Asking auditors to attest to management assessments of the explanations for financial performance or condition, assessments of the impact of trends or uncertainties or forward-looking assessments of future performance or condition not only puts auditors well outside their core expertise, but also carries with it a significant risk that the audit process would lead to less rather than more "good" MD&A. Enhanced auditing standards should contribute to good disclosure under the Commission's rules and not work at cross-purposes, as we fear would be the case with application of auditing standards to MD&A.

Granted, MD&A does include financial information derived from an issuer's financial statements and other financial metrics, but auditors already review financial statement numbers in the MD&A as part of their audit procedures. The Board could consider whether the auditor review of such financial information similar to what they do as part of the standard comfort process under Statement on Auditing Standards 72, Letters for Underwriters and Certain Other Requesting Parities ("SAS 72") ought to be formally embodied in the audit and review process. In fact, a number of large issuers already request their auditors to conduct a SAS 72 review when those issuers prepare their Annual and Quarterly Reports on Forms 10-K and 10-Q in order to facilitate shelf offerings. We would be very concerned, however, that requiring smaller entities, especially those that do not regularly access the capital markets, to follow such procedures would be an unwarranted additional burden. Given that auditors already check the MD&A for consistency with the financial statements, we feel that requiring additional review procedures for financial information derived from the issuer's financial records might well add cost with little countervailing benefit. Furthermore, we are concerned that requiring additional procedures will make timely reporting more difficult and may cause issuers to reduce the financial information they include in MD&A.

B. Earnings Releases

A related subject that was not discussed at length in the Release but received much attention at the September 15, 2011 Roundtable was the idea of providing for additional auditor involvement in issuer earnings releases and Quarterly Reports on Form 10-Q. Certain participants seemed concerned that the results of an audit (in the case of annual earnings) or review under Statement on Auditing Standards 100 Interim Financial Statements ("SAS 100") (in the case of earnings in the first three quarters of the issuer's fiscal year) become available several weeks after earnings and other financial information are made available through an

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[8] *See* SEC Nos. 33-6835; 34-26832; IC-16961; FR-36 (May 1989) and SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

[9] In the 2003 Release, the SEC noted that in approaching MD&A "[m]anagement has a unique perspective on its business that only it can present. As such, MD&A should not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides this important management perspective." SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

earnings release. Certain participants also queried whether the information and value conveyed by the audit and accompanying auditor's report or SAS 100 interim review, as the case may be, was as timely as it could be for the benefit of investors.

In our experience, management and audit committees almost always have auditors consider and review the financial information included in earnings releases. In particular, issuers in our experience recognize the dangers of a change from results reported in an earnings release in subsequent periodic Commission filings, and involve their auditors at the earnings release stage to help reduce that risk. We are concerned that formalizing this process would not be feasible within the current time constraints and that the costs would outweigh the benefits.

In addition, with respect to increasing the auditor's involvement in the review of Quarterly Reports on Form 10-Q, our experience is that the auditor involvement in a review of quarterly filings under SAS 100 does lead to enhanced quality and reliability of interim financial reporting. In particular, the process of auditor review, the communications of the auditor to the audit committee and the dialogue between the auditor and audit committee all contribute to this result. We believe these same factors were extensively considered at the time the mandatory quarterly review process was adopted in SAS 100, and we do not believe there have been significant developments since then that should favor moving to an audit of interim financial statements. Furthermore, requiring an audit of quarterly financial statements would no doubt delay quarterly reporting and add significantly to expense such that the increased burdens would, in our view, clearly outweigh the benefits. Indeed, the additional burden on issuers following the acceleration of filing deadlines for Quarterly Reports on Form 10-Q for larger issuers in 2004, while by only five days, would suggest that any change that introduces further time constraints in this area should not be made.

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

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: Public Company Accounting Oversight Board
Hon. James R. Doty, Chairman
Hon. Lewis H. Ferguson, Member
Hon. Daniel L. Goelzer, Member
Hon. Jay D. Hanson, Member
Hon. Steven B. Harris, Member

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