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December 11, 2013

Via E-mail: comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 34 –
Proposed Auditing Standards – The Auditor’s Report
on an Audit of Financial Statements When the Auditor
Expresses an Unqualified Opinion; and
The Auditor’s Responsibilities Regarding Other
Information in Certain Documents Containing Audited
Financial Statements and the Related Auditor’s Report

Ladies and Gentlemen:

This letter is in response to the proposed auditing standards relating to auditor’s reports on financial statements issued by the Public Company Accounting Oversight Board (the “Board”) in PCAOB Release No. 2013-005 (August 13, 2013) (the “Release”). We appreciate the opportunity to submit these comments for the Board’s consideration.

We previously commented to the Board’s 2011 Concept Release on the audit report. Those comments, based on our perspective as lawyers regularly engaged advising issuers on disclosure and reporting matters, were animated by two key considerations:

- the issuer must be the original source of any disclosure about the issuer or its results of operations or financial position, and
- the best way to capture, for the issuer and its shareholders, the benefits of the auditor’s insights and experience is for the auditor to have full and open interaction with the audit committee.

The proposed auditing standards do not reflect some of the more troubling potential changes considered in the Concept Release – such as the proposed “auditor’s discussion and analysis” – but do include elements that in our view are likely to have unintended consequences that increase costs and are detrimental to the quality of issuers’ disclosure and their governance processes.

The proposed requirement to include discussion of “critical audit matters” in the audit report significantly implicates these concerns. On a very basic level, in the context of an audit report that continues to state a “pass/fail” conclusion, we do not understand how a discussion of critical audit matters truly serves a useful disclosure purpose. The discussion appears to be pointing out areas of uncertainty, but we assume that it is not meant to convey uncertainty as to the basic “pass/fail” conclusion of the audit. Is it then intended to indicate uncertainty as to the information disclosed by the issuer? It seems to us that disclosure as to this sort of uncertainty is best left to the issuer itself. Indeed, issuers are required to disclose known trends and uncertainties in management’s discussion and analysis of financial condition and results of operations (MD&A), and MD&A also includes a discussion of critical accounting estimates. Areas of uncertainty addressed in the audit process are at best a second-order indicator of the quality of the issuer’s disclosed information. Someone engaged in direct discussions with the issuer – such as underwriters conducting due diligence discussions, or an audit

committee overseeing the issuer's financial reporting – could follow-up on this sort of indicator and ask further, targeted questions as to the underlying state of affairs. But an investor reading financial statements does not have that opportunity to follow-up. For the investor, the significance of the critical audit matters disclosed seems uncertain and questionable, at best.

At the same time, any discussion of critical audit matters will, we think, necessarily expand disclosure about the issuer, and in particular about the issuer's internal control over financial reporting. For example, we would expect a critical audit matter requirement to lead to extensive disclosure and discussion of "significant deficiencies" in internal control. Indeed, the proposed standard provides that the "severity of control deficiencies identified" is a factor that the auditor should take into account in determining a critical audit matter. While some might view that as useful disclosure, for present purposes we think the key point is that any expansion (or effective expansion) of disclosure requirements in this area should be the result of Securities and Exchange Commission rule-making, with notice and comment, and not the by-product of new PCAOB auditing standards.

We are also concerned that a requirement to discuss critical audit matters may have, as an unintended consequence, a tendency to discourage free and open communication between the auditor and management and between the auditor and the audit committee and, to the extent issuers and audit committees may have an influence, between auditors and their respective national offices. As we read the proposed auditing standard, such communications could be taken as indicators of critical audit matter status. For any number of reasons, issuers and auditors may wish to limit, or otherwise influence, the number of critical audit matters that must be addressed, and seek to do so by limiting such communications. This would obviously be a most unfortunate effect,

but we are quite concerned that it would be a real motivating factor for issuers and their auditors operating under the proposed standard. We are also concerned that discussion of critical audit matters in the audit report will lead issuers to feel compelled to make reactive disclosures, resulting in added costs and burdens to them. At the same time, it will have the effect of causing the auditor to be a source of disclosure about the issuer and its financial reporting rather than an independent auditor of the issuer's financial information, thus both changing and blurring the role of the auditor.

Our principal concern with the proposed "other information" standard also relates to unintended consequences. This standard would require addition to the audit report of a very simple, blanket confirmation. We expect most readers would understand that confirmation to provide additional "comfort" as to the other information covered or worse, that the other information is somehow being "expertised". Notwithstanding the contemplated disclaimers (as to the basis of the evaluation, and that no opinion is being expressed on the other information), we are therefore concerned that a requirement to provide such confirmations will provide auditors a powerful incentive to do more work to support the statement. On the other hand, if that is not the result, given the impression conveyed by the confirmation, we are concerned that the new requirement will have effectively widened the "expectations gap" between what investors believe the auditors are doing, and what they in fact do. As an example, the proposed standard would treat as "other information" any documents in the list of exhibits to the annual report on Form 10-K¹. Putting aside the time and expense associated with having an auditor read and evaluate the information in those documents, we question whether the auditor has any particular expertise with respect to evaluating many of the documents so filed. Moreover, although the proposed standard would have the auditor state that her

¹ Appendix 6 of the proposed standard, page A6-6.

evaluation of the other information was based on the relevant “audit evidence obtained and conclusions reached”, we doubt the average investor will appreciate the limits that statement is intended to convey, thereby aggravating the “expectation gap”.

We are also concerned that the new requirements, as to both “critical audit matters” and “other information”, may expose the auditors to additional potential liability, unfairly in our view, since the auditor would be required to make comments on the basis of information acquired incidentally in the course of the audit, as opposed to as a result of procedures designed specifically to develop such disclosure. And we fear that auditor disclosures of the sort contemplated would likely enhance the issuer’s liability profile, as well.

We continue to believe it is quite important that issuers (and derivatively, their shareholders) get the full benefit of the auditor’s insights acquired through the course of the audit. But we feel strongly that requiring the auditor to make public substantive disclosures about “critical audit matters” and “other information” will not promote that objective, and may well inhibit the audit and governance processes now in place to oversee financial reporting. Auditors should be encouraged to have the fullest and frankest conversations possible within their firms and with the audit committee. The best way to promote that objective is to allow those conversations to be conducted on a confidential basis. We continue to be quite concerned that if the auditor’s discussions within the firm and with the audit committee are conducted with the anticipation of subsequent public disclosures being made by the auditor, these internal and auditor/audit committee discussions may be seriously inhibited. Auditors may be more cautious in raising concerns, and audit committee members may be more circumspect in probing such concerns with the auditor.

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We appreciate this opportunity to comment on the proposed auditing standard. You may direct any questions with respect to this letter to Robert E. Buckholz at (212) 558-3876, Robert W. Downes at (212) 558-4312 or William G. Farrar at (212) 558-4940.

Very truly yours,


SULLIVAN & CROMWELL LLP