CFA **Consumer Federation of America**

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Rulemaking Docket Matter No. 034

Dear Sir or Madam:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our support for the proposal to revise and expand the auditor's report and to urge the Board to do more to make the auditor's report a useful document for investors. Investors have made clear their dissatisfaction with the current auditor reporting model, which provides no real information of value beyond an up or down opinion as to whether the audited financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. As currently designed, the report does nothing to distinguish between the audits of companies with straight-forward financial statements and those that present a number of auditing challenges, for example. Nor does it distinguish between those that take a relatively conservative approach to complex accounting issues and those that are more aggressive in their approach. This proposal represents a welcome step toward addressing critical shortcomings in the current auditor's reporting model which will, in turn, enable investors to better assess companies' financial reporting.

Background

More than two years ago, CFA joined with other members of the PCAOB's Investor Advisory Group in writing to the Board to urge more extensive revisions to the auditor's report.[2] While we appreciate that the current proposal reflects a partial response to that request, we are nonetheless disappointed that key aspects of our recommendations have not been included in the

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[1] CFA is a non-profit association of nearly 300 national, state and local pro-consumer organizations. I was founded in 1968 to represent the consumer interest through research, advocacy and education.

[2] See, September 29, 2011 letter from twelve members of the PCAOB Investor Advisory Group to the PCAOB Office of the Secretary regarding PCAOB No. 2011-003, Rulemaking Docket No. 34, "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards." We incorporate that letter by reference.

Board's proposal. As a result, the current proposal falls short, in our view, of what could and should be done to transform the auditor's report into a document that provides investors with valuable information to consider in evaluating their current and potential investments. We therefore urge the Board to reconsider those approaches recommended by investors but absent from this proposal. At a minimum, the Board must resist pressure from some issuers and auditors to further scale back the current welcome, but modest proposal.

The fact that investors want additional information from auditors and that it is both feasible and affordable for auditors to provide that information ought to ensure the proposal's adoption. After all, investors have said that receiving more information about the audit would allow them to make more informed investment decisions. More informed investment decisions lead to better and more efficient allocation of capital, and that benefits not only investors but also the health of the financial markets as a whole.

Revision of the auditor's report can help to address other important policy goals as well. For example, both Board members and leaders at the SEC have expressed concern in recent years over a lack of professional skepticism in the audits of public companies. At the same time, evidence has mounted that many audit committees do not effectively serve their audit oversight function.[3] And, past experience has shown that there will always be companies that will test the limits of acceptable financial reporting and auditors who will let them cross that line. While far from a silver bullet, a well-designed expanded auditor's report has the potential to help address each of these problems. At the simplest level, expanding the auditor's report can serve as a much needed reminder that it is the investors, and not management, who are the real audit clients and that it is their interests that the audit is intended to serve.

Consistent with the theory that sunlight is the best disinfectant, requiring a discussion of critical audit matters and how they were addressed in the audit can also have a salutary effect on the conduct of both issuers and auditors. Those issuers who are most aggressive in their approach to financial reporting may be reluctant to have that tendency highlighted in the audit report through a discussion of the audit challenges that resulted. Whereas the current audit report creates an incentive for such issuers to adopt the most aggressive reporting consistent with an unqualified opinion, an expanded discussion of critical audit matters may provide a counter incentive to adopt more conventional, widely accepted financial reporting approaches. At the same time, auditors who realize they will be required to report publicly on their handling of such issues may be more likely to demonstrate the professional skepticism necessary to promote a high quality of financial reporting. Thus, the required reporting may strengthen the auditor's hand in negotiating contentious issues with management. In each of these examples, the auditor's report would better serve this function if, as we have previously recommended, it also included a discussion of management's estimates and judgments and how the auditor arrived at its assessment of those estimates and judgments and an opinion on the quality, and not just the acceptability, of the company's accounting.

[3] See, for example, the discussion at the October 16, 2013 meeting of the PCAOB Investor Advisory Group, which suggested that, because of weaknesses in the board election process and in the definition of financial expert, many audit committees may lack both the independence and financial expertise necessary to provide effective oversight.

The following discusses key issues related to this proposal in greater detail. This comment is focused exclusively on the proposal to include a discussion of critical audit matters in the audit report.

1) Investors and other users of financial statements want more information from auditors than they currently receive.

Extensive evidence exists that investors and other users of the audit report want more information from auditors than the current audit report provides. Improving the content of the audit report has been identified as a priority by members of the PCAOB's Investor Advisory Group (IAG). As part of its consideration of the issue, the IAG weighed results of surveys conducted by the CFA Institute in 2008 and 2010 which indicated that a large majority of analysts want more information from the auditor's report.[4] To further its understanding of the issue, the IAG itself conducted a survey of investors in advance of its March 2011 meeting, the results of which were reported on at that meeting. The IAG survey sought input both on investors' perceptions of the value of the current audit report and on their views regarding needed changes. The IAG survey identified the following as the four most highly desired changes to the audit report:

- a discussion of the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment (desired by 79 percent of survey respondents);

- disclosure of areas of high financial statement and audit risk and how the auditor addressed these risk areas in planning and conducting the audit (desired by 77 percent of survey respondents);

- discussion of unusual transactions, restatements, and other significant changes in the financial statements (desired by 67 percent of survey respondents); and

- discussion of the quality, not just the acceptability, of the issuer's accounting practices and policies (desired by 65 percent of survey respondents).

The analysts and institutional investors surveyed by CFA Institute and the IAG respectively are among the primary users of financial statements and, by extension, the audit report. As such, their views should carry particular weight with the Board. They have made clear in this and other contexts that they believe that expanded communications from the auditor would help them to better evaluate the financial statements of the companies in which they invest.

2) The proposal delivers some, but not all of the information investors would like to receive from auditors.

The Board's proposal takes a related but somewhat different approach than investors have suggested by requiring disclosure of "critical audit matters" specific to the particular audit

[4] CFA Institute. 2008. February Monthly Question Results. Cited in *Final Report of the Advisory Committee on the Auditing Profession*. VII: 16; CFA Institute. 2010. *Independent Auditor's Report Survey Results*.

that is the subject of the report. As described in the proposing release, the auditor's required communication would focus on "those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements." The proposal further notes that these would generally be "matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document, which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three." Based on this description, there would appear to be significant overlap between the "critical audit matters" covered by the proposal and the information investors have previously indicated they want to receive. In particular, areas of financial statement and audit risk ought clearly to be covered under the Board proposal. Information about estimates and judgments and about unusual transactions could also be covered where they rise to the level of importance and posed the degree of audit challenge that would meet the standards for critical audit matters identified in the proposal.

Arguably the biggest divergence between the proposal and the information requested by investors is that the proposal focuses exclusively on information about the audit and avoids any discussion of the auditor's assessment of the financial statements, either with regard to estimates and judgments or more generally with regard to the overall quality of the financial reporting. This appears to reflect a conscious choice by the Board to avoid any changes that would put auditors in the position of providing "information, including any analysis, about the company's financial statements to financial statement users." We strongly object to this proposed limitation on auditor communications. There is no statutory reason that we are aware of why auditors should be precluded from discussing with investors their chief impressions of the quality of a company's financial reporting. Moreover, by failing to include this sort of assessment in its proposed revisions, the Board diminishes the proposal's most important potential benefit – its potential to improve the quality of financial reporting. The Board has not provided sufficient justification for the narrowed focus of this proposal (as we discuss further below).

Despite these significant limitations, the Board has in our view otherwise done a good job of designing the proposed additions to the audit report. Whenever new disclosures are proposed, a key consideration is whether the information will be communicated in a manner that truly promotes enhanced investor understanding. In this instance, the Board has proposed an approach to disclosing critical audit matters that, properly implemented, should provide valuable information to the users of financial statements. The specific sample disclosures provided by the Board make clear that the new disclosures can and should be presented in a way that provides genuine insights into the most challenging issues that arose in the course of the audit and how they were addressed. Despite the best intentions of the Board, however, there is an unavoidable risk that audit firms will implement the new requirement through the provision of boilerplate or cursory disclosures. There is a similar risk that auditors, who will have ultimate responsibility for determining what issues to disclose, will be too narrow in their approach.

In both these instances, the Board will need to provide effective supervision and enforcement of the proposed rule's implementation to ensure that it delivers the intended benefits. We nonetheless agree that the facts-and-circumstances based approach to determining what must be disclosed is the appropriate approach for the Board to adopt. Moreover, the guidance provided in the release, which suggests that most audits would be expected to involve critical audit matters, helps to send the right message about appropriate implementation.

3) It is both feasible and affordable for auditors to provide the information investors want in the audit report.

In determining whether to move forward with this proposal, the key questions the Board should address are: What information do investors want? And is it possible to provide the information investors want at a reasonable cost? As the Board notes in the proposing release, the proposed revisions to the auditor's report would not require auditors to gather much if any additional information. Furthermore, as the proposing release makes clear, critical audit matters are by definition matters that auditors are almost always already communicating in the engagement completion document, to the audit quality reviewer, and/or to audit committees. Thus any additional incremental cost of providing a brief summary of the information in the audit report should be minimal and far outweighed by the benefits to investors and to efficient capital allocation.

The same holds true for the information that investors have sought that is *not* included in the current proposal. This includes the auditor's assessment of key estimates and judgments in the financial statements, as well as the auditor's assessment of the quality, and not just the acceptability, of the company's financial reporting. An auditor could not complete a quality audit without reaching conclusions on these matters. Here again, auditors are already collecting this information and communicating it to audit committees. For example, AU ¶ 380.08 requires the auditor to ensure that the audit committee is informed "about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates." Similarly, AU ¶ 380.11 requires that, "In connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting." Thus, a decision not to include the further information investors desire in the current proposal cannot be justified on cost grounds.

4) The proposal should be strengthened.

The Board proposal represents a positive step toward delivering the information investors desire, but it stops well short of providing the full range of information investors have indicated they would like to receive from auditors (as discussed further above). The limitations of the proposal in this regard appear to be driven by a desire on the part of the Board to address concerns raised by issuers and auditors over having auditors report on the quality of financial reporting rather than on an evaluation of the proposals on their own merits. The resulting narrow focus on issues directly related to the audit limits the potential effectiveness of the proposed changes.

The decision-making process reflected here also represents a fundamental misunderstanding of the Board's proper role. Specifically, the Board's responsibility is not to negotiate a compromise between issuers, auditors, and investors, but to serve the public interest.

The Board can best achieve that by adopting standards that make auditors more accountable to the investing public, enhance auditor independence and professional skepticism, and improve the quality of financial reporting. An expanded auditor's report has the potential to contribute to all three goals. Thus, in a case such as this where the potential benefits are significant and investors have made their preferences clear, the Board should see its obligation as delivering those changes viewed as beneficial by investors that can be accomplished at a reasonable cost and consistent with the relevant securities laws.

Such an analytical approach would clearly support not just the existing proposal, but also the broader reforms advocated by investors. For example, on what policy grounds has the Board concluded that it would be inappropriate for auditors to communicate to investors their assessment of management estimates and judgments? On what policy grounds has the Board concluded that it would be inappropriate to put auditors in the role of commenting on the quality of a company's financial reporting? The fact that some issuers and auditors are uncomfortable with that approach is not sufficient justification.

Another argument that has been put forward is that having auditors communicate such matters directly with investors would somehow weaken the role of audit committees. This is patently absurd. Good corporate boards and audit committees will continue to conduct their oversight functions effectively. At companies where board oversight has been less than effective, however, knowing that there will be greater public accountability could serve to reinvigorate audit committee oversight of the audit as well as broader board oversight of the financial reporting process. At a minimum, it would help to reduce the risk that investors will pay the price when boards fail to perform their governance functions effectively.

Similarly, some opponents of the proposed changes have argued that investors might be confused by the information provided. They offer no explanation, however, why this information would be any more confusing than the information provided in financial statements and other disclosure documents relied on by investors when making investment decisions. Moreover, this argument would seem to suggest that auditors and issuers believe they know better than investors what information they would find valuable. We reject that notion, and urge the Board to do so as well.

In short, given the strong preference among investors for expanded disclosures from auditors, the significant potential benefits of providing that information, the weak and self-serving arguments against expanded disclosures, and the feasibility of adopting the proposed changes at minimal cost, we believe the clear imperative for the Board is to move forward with the proposed changes.

Conclusion

The primary and laudable goal of this proposal is to transform the auditor's report into a document that provides investors with information that assists them in making informed investment decisions. That directly benefits investors, but it also improves the capital formation process and thus enhances the overall health of the markets. Thus the proposed changes – and the broader changes advocated by investors – can be justified on these grounds alone.

But changing the auditor's reporting model should also be seen as one part of a broader reform agenda designed to make auditors more accountable to the investing public, to enhance auditors' professional skepticism, and to strengthen their hand in negotiating contentious financial reporting issues with management. While the proposal to include a discussion of critical audit matters in the audit report provides modest additional benefits in these areas, these goals would be better served by a broader reform of the audit report to include the auditor's assessment of the company's financial reporting, including in the area of estimates and judgments. Investors have expressed a strong interest in receiving this information. Thus, while we support the current proposal to add a discussion of critical audit matters to the audit report, we urge the Board to go further and incorporate the additional disclosures sought by investors in its revisions to the auditor's reporting model.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection