

Via Email

August 8, 2017

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, DC 20549-1090

Re: File Number PCAOB-2017-01

Dear Mr. Secretary:

The purpose of this letter is to provide you with the Council of Institutional Investors' (CII or Council) comments in response to the U.S. Securities and Exchange Commission (SEC or Commission) notice to solicit comments on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed rules on the auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion, and departures from unqualified opinions and other reporting circumstances, and related amendments to auditing standards (Proposed Rules).¹

The Council is a non-profit, nonpartisan association of public, corporate, and union pension funds, and other employee benefit plans, foundations and endowments with combined assets that exceed \$3 trillion. Our member funds are major, long-term investors committed to protecting the retirement savings of millions of American workers. CII also has associate members, including asset managers with more than \$20 trillion in assets under management.²

We thank the SEC and the PCAOB for pursuing one of the most important recommendations contained in the U.S. Department of Treasury's 2008 *Final Report of the Advisory Committee on the Auditing Profession* – "to consider improvements to the auditor's standard reporting model."³ The Board has adopted the Proposed Rules after more than six years of outreach, including three documents issued for public comment, and careful consideration of input from a broad range of market participants including members of the PCAOB's Standing Advisory

¹ PCAOB, Exchange Act Release No. 81,187, 82 Fed. Reg. 35,396, 35,396 (July 28, 2017), available at <https://www.gpo.gov/fdsys/pkg/FR-2017-07-28/pdf/2017-15718.pdf>.

² For more information about the Council of Institutional Investors ("CII"), please visit CII's website at http://www.cii.org/about_us.

³ Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury VII:13 (Oct. 6, 2008), <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>.

Group and Investor Advisory Group.⁴ We strongly recommend that the Commission promptly approve the Proposed Rules and we offer the following comments.

CII Policies

As the leading U.S. voice for effective corporate governance and strong shareholder rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed decisions, and vital to the overall well-being of our capital markets.⁵ That strong belief is reflected in the following CII membership-approved policy on the “Independence of Accounting and Auditing Standard Setters:”

Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the . . . standards that . . . auditors use in providing assurance that the preparers’ recognition, measurement and disclosures are free of material misstatements or omissions.⁶

This policy establishes the principle that “investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors’ information needs.”⁷ Our membership reaffirmed that principle when it approved substantial revisions to our policy on “auditor independence.”⁸ That policy, as revised, includes the following additional provisions that we believe are relevant to issues raised by the Proposed Rules:

2.13a Audit Committee Responsibilities Regarding Independent Auditors: The audit committee should fully exercise its authority to hire, compensate, oversee and, if necessary, terminate the company’s independent auditor. In doing so, the committee should take proactive steps to promote auditor independence and audit quality. Even in the absence of egregious reasons, the committee should consider the appropriateness of periodically changing the auditor, bearing in mind factors that include, but are not limited to:

- the auditor’s tenure as independent auditor of the company

⁴ See PCAOB, Fact Sheet: Adoption of an Auditing Standard on the Auditor’s Report 4 (June 1, 2017), <https://pcaobus.org/News/Releases/Pages/fact-sheet-auditors-report-standard-adoption-6-1-17.aspx>; 82 Fed. Reg. at 35,396.

⁵ CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (updated Mar. 1, 2017), http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

⁶ *Id.*

⁷ *Id.*

⁸ CII, Policies on Corporate Governance § 2.13 Auditor Independence (last updated Sept. 30, 2016), http://www.cii.org/corp_gov_policies.

....

- the clarity, utility and insights provided in the auditor’s report

....

Investors are the “customers” and end users of financial statements and disclosures in the public capital markets. Both the audit committee and the auditor should recognize this principle.

....

2.13b Competitive Bids: The audit committee should seek competitive bids for the external audit engagement at least every five years.

....

2.13f Shareowner Votes on the Board’s Choice of Outside Auditor: Audit Committee charters should provide for annual shareowner votes on the board’s choice of independent, external auditor.⁹

CII Views on Proposed Rules

Critical Audit Matters (CAMs)

We support the Proposed Rules’ auditor reporting model that requires the independent auditor to communicate CAMs in the auditor’s report.

Benefits to Investors

We believe that the required communication of CAMs will make the auditor’s report more relevant and useful to investors and other readers by providing tailored, audit-specific information directly from the auditor’s point of view. More specifically, we agree with the Board that:

Reporting of [CAMs] should provide insights that will add to the mix of information that could be used in investors’ capital allocation decisions, for example, by:

- Highlighting the aspects of the financial statement audit that the auditor found to be especially challenging, subjective, or complex;
- Enabling comparison of these aspects of the audit across companies, for example audits of companies within the same industry; and
- Enabling comparison of these aspects of the audit over time.¹⁰

We believe the CAMs will also benefit institutional and retail investors (or others who may act on their behalf, such as analysts, credit rating agencies, or the financial press) because it will lead management to improve the quality of its disclosures or adopt more representationally faithful financial reporting approaches in those areas addressed by the CAMs.¹¹ Finally, we believe the

⁹ *Id.*

¹⁰ 82 Fed. Reg. at 35,416.

¹¹ *See, e.g.,* Sullivan & Cromwell LLP, Audit Reports, PCAOB Releases Reproposal of Amendments to Its Audit Report Standard 3-4 (May 25, 2016) (advising that management should consider “revis[ing] or supplement[ing] its

CAMs will benefit investors, particularly institutional investors, in engaging with management and the audit committee, and when voting on the ratification of the auditor and on the election or reelection of the audit committee chair and members.

Boilerplate Language

We are optimistic that the U.S. audit profession will faithfully implement the required communication of CAMs in the manner intended by the Proposed Rules so that the communication is “tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.”¹² Investors do not expect public companies to issue identical annual reports every year, and will certainly not expect the auditor to issue identical auditor reports.¹³

Our optimism that CAMs will not become boilerplate is buoyed by the experience with an extended audit report in United Kingdom (U.K.), which is similar to the report required by the Proposed Rules.¹⁴ As described by the Board, the U.K. Financial Reporting Council “found that, in the second year [2015] of expanded auditor reporting in the [U.K.], the discussion of risks has improved relative to the first year of implementation and that the majority of auditor’s reports provided discussion of risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.”¹⁵

More broadly, we note that the U.K. extended auditor report “has been welcomed not only as a means to provide additional information to investors, but also as a means for accounting firms to compete among themselves and distinguish their particular brand and quality.”¹⁶ We fully expect the U.S audit profession will embrace the Proposed Rules and view them as an opportunity to demonstrate their value to investors.

Audit Committee –Auditor Relationship

We believe the required communication of CAMs will enhance the quality of communications between the audit committee and the external auditor and improve the audit committee-auditor

own disclosures, in light of the auditor’s discussion, in order to ensure that the totality of the disclosure reflects an accurate and complete picture”),

https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Audit_Reports_05_25_2016.pdf.

¹² 82 Fed. Reg. at 35,403.

¹³ ICAEW, The Start of a Conversation, The Extended Audit Report 7 (2017) (“Clearly the directors do not issue identical annual reports every year, so why would the auditor issue an identical audit report?”),

<https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/audit-and-assurance-faculty/publications/extended-audit-report.ashx?la=en>.

¹⁴ See, e.g., Steven B. Harris, Board Member, PCAOB, Statement on Adoption of an Auditing Standard on the Auditor’s Report 4 (June 1, 2017), <https://pcaobus.org/News/Speech/Pages/Harris-statement-auditors-report-standard-adoption-6-1-17.aspx>.

¹⁵ 82 Fed. Reg. at 35,424.

¹⁶ Steven B. Harris at 4; see, e.g., Letter from Paul Smith, CFA, President and Chief Executive Officer, CFA Institute, to Chairman Jay Clayton, U.S. Securities and Exchange Commission 6 (June 12, 2017) (“ In the United Kingdom, for example, where the recommendations of the report have been adopted, investor feedback has been positive.”) (on file with CII).

relationship.¹⁷ While the Proposed Rules do not generally change the existing requirements on audit committee communications, we believe they will provide “an additional incentive for the audit committee to engage with the auditor and management about the matters identified as [CAMs] and the adequacy of the company’s related disclosures.”¹⁸ Our belief is bolstered by the experience to-date with the implementation of expanded auditor reporting in the U.K.¹⁹

Potential Liability

We applaud the Board for a thorough and comprehensive analysis of “what effect the communication of CAMs would have on private liability”²⁰ We note that the Board is fortunate to have as members’ three incredibly talented and accomplished legal experts with extensive corporate/securities law experience and knowledge.

We believe that since communication of CAMs is about disclosure of risks and challenges, the Proposed Rules’ required communication of such matters may have the potential to actually decrease liability in private litigation.²¹ In any event, we agree with the ultimate conclusion of the Board that

[CAMs] will not replace or alter the fundamental requirement that the auditor’s report include the auditor’s opinion that the financial statements are fairly presented in accordance with the applicable financial reporting framework, which has been, and the Board expects will continue to be, the primary statement at issue in most private securities litigation²²

We also agree with the comment of one of the four largest U.S. auditing firms that concerns about potential liability “should not stand in the way of moving forward.”²³

Additional Costs

At the outset, we note that commenters to the Proposed Rules did not provide the Board with empirical data or quantified estimates of the costs or other potential impacts of the standard

¹⁷ See, e.g., 82 Fed. Reg. at 35,399 (“the Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing”).

¹⁸ *Id.* at 35,421.

¹⁹ *Id.* at 35,425 (“the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications”).

²⁰ *Id.* at 35,407.

²¹ *Id.* (“one commentator noted that the communication of critical audit matters is about disclosure of risks and challenges and expressed the belief that non-communication of such matters would be more problematic from a litigation point of view”).

²² *Id.*; see generally U.S. Department of the Treasury at VII:31 (“Investors, particularly institutional investors with fiduciary obligations to fund beneficiaries, believe the right to seek recovery when auditors participate in fraud or have breached their professional duties is both an important motivator of audit quality and an important mechanism for holding auditing firms accountable to the investing public.”).

²³ Letter from Deloitte & Touche LLP 5 (Aug. 12, 2016), https://pcaobus.org/Rulemaking/Docket034/041c_Deloitte.pdf.

despite repeated solicitation for such information.²⁴ In our view, the additional costs for the required communication of CAMs would not likely be material as those matters would generally already have been required to be communicated to the audit committee.²⁵ Thus, a substantial amount of the work to communicate CAMs would already have been required to be completed earlier in the audit.²⁶

To the extent the Proposed Rules create additional costs, we believe the benefits of expanded auditor reporting justify those costs.²⁷ Moreover, as shareowners, we are willing to bear the additional costs in exchange for the required additional information.²⁸

Other Proposed Changes to Auditor's Report

We also support the Proposed Rules' other improvements to the auditor's report. Specifically, we believe the required information regarding auditor tenure will be useful to investors in deciding whether to vote to ratify appointment of the auditor and on the election or reelection of the audit committee chair and members. As support for our view, we note the existence of academic research indicating that investors view long-term auditor-company relationships as adversely affecting audit quality.²⁹

We also note the recent comments of the SEC Chief Accountant indicating that, consistent with our policies, disclosure of audit tenure may be relevant to the audit committee's selection and oversight of the auditor.³⁰ Finally, we believe that since the auditor's report is the primary means by which the auditor communicates with investors, it is appropriate for the Proposed Rules to require auditor tenure to be included in the auditor's report. Required inclusion in the auditor's report has at least two ancillary benefits to investors (1) "[it] will make information available earlier to investors [than other alternatives like Form AP] . . . , which may assist in their voting on auditor ratification;"³¹ and (2) it "poses lower search costs."³²

²⁴ 82 Fed. Reg. at 35,415.

²⁵ *Id.* at 35,423 ("commenters said that there would not be material additional costs for communication of critical audit matters, as these matters would already have been communicated to the audit committee").

²⁶ *Id.* ("This may suggest that a substantial amount of the work required to communicate critical audit matters would already have been completed earlier in the audit.").

²⁷ *Id.* ("investors would be expected to ultimately bear the cost of the audit, and these commenters have voiced strong support for expanded auditor reporting since the project's inception").

²⁸ *Id.* ("This suggests that they [investors] consider the benefits of expanded auditor reporting to justify the costs, and would support additional fees for additional useful information.").

²⁹ *See, e.g.,* Mai Dao et al., Auditor Tenure and Shareholder Ratification of the Auditor, 22 *Acct. Horizons* 297, 297-314 (2008), available at

https://www.researchgate.net/publication/247874460_Auditor_Tenure_and_Shareholder_Ratification_of_the_Audit_or.

³⁰ Wesley R. Bricker, Chief Accountant, Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets" 3 (June 8, 2017) ("an audit committee may want to incorporate prior auditor service into its oversight of the auditor's expertise, incentives and, ultimately, appropriate performance in the conduct of the audit"), <https://www.sec.gov/news/speech/bricker-remarks-financial-reporting-institute-conference-060817>.

³¹ 82 Fed. Reg. at 35,428.

³² *Id.*

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We appreciate the opportunity to provide the Council's investor-focused perspective on this long sought and long overdue improvement to the auditor's report. Please let me know if you have any questions about the contents of this letter.

Sincerely,

A handwritten signature in blue ink that reads "Jeff Mahoney". The signature is written in a cursive style with a long, sweeping underline.

Jeffrey P. Mahoney
General Counsel