ATTACHMENT

Responses of the Council of Institutional Investors ("CII") to Select Questions Contained in the Proposed Auditing Standards
PCAOB Rulemaking Docket Matter No. 034[1]
December 16, 2013

Proposed Auditor Reporting Model

<u>Questions Related to Section IV:</u>

2. **The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?[2]**

CII generally believes that that the final auditor reporting standard should require that the auditor's report be addressed to investors in the company. We note that our membership approved corporate governance policies have long reflected 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 timely manner investors' information needs." [3] Our membership reaffirmed that principle last April when approving substantial revisions to our membership-approved policy on "Auditor Independence*.*"[4] That policy includes the following provision:

> 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.[5]

Consistent with our policies, we generally agree with the Public Company Accounting Oversight Board ("PCAOB or "Board") that "the requirement for the auditor's report to be addressed to investors might serve as a [helpful] reminder to the auditor that the auditor's ultimate customer is the investor."[6]

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[1] PCAOB Release No. 2013-005 (Aug. 13, 2013), *available at* http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf.
[2] *Id.* at A5-20.
[3] CII Statement on Independence of Accounting and Auditing Standard Setters 2 (adopted Oct. 7, 2008), *available at* http://www.cii.org/policies_other_issues#indep_acct_audit_standards.
[4] CII, Corporate Governance Policies § 2.13 Auditor Independence (last updated Sept. 27, 2013), *available at* http://www.cii.org/files/committees/policies/2013/09_27_13%20CII%20Corp%20Gov%20Policies%20Full%20and%20Current%20%20FINAL.pdf.
[5] *Id.*
[6] PCAOB Release No. 2013-005 at A5-9.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**[7]

CII generally believes that a statement in the auditor's report relating to auditor independence would provide useful information regarding the auditor's responsibility to be independent. As indicated in response to question 2, our membership-approved corporate governance policies relating to the audit are included under a single heading, entitled "Auditor Independence," a sign of the great weight that our members ascribe to the independence of the external auditor.[8] We, therefore, generally agree with "the Board's view [that] . . . adding a statement relating to auditor independence in the auditor's report could . . . serve as a reminder to auditors of these obligations."[9]

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

   a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

   b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

   c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**[10]

CII generally believes that information regarding auditor tenure in the auditor's report would be useful to investors and other financial statement users. We note that our membership-approved corporate governance policies on "Auditor Independence" contain the following three explicit references to auditor tenure:

(1) In connection with the audit committee's consideration of the appropriateness of periodically changing the auditor;[11]

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[7] *Id.*
[8] § 2.13 Auditor Independence.
[9] PCAOB Release No. 2013-005 at A5-14.
[10] *Id.* at A5-20 to 21.
[11] § 2.13a Audit Committee Responsibilities Regarding Independent Auditors.

(2) In connection with the audit committee's consideration of what should be reported to shareowners as an explanation for not changing the company's auditor;[12] and
(3) In connection with the audit committee's consideration of when it should seek competitive bids for the external audit engagement.[13]

We generally agree with the Board that there is "strong interest in this information" from investors.[14]

The ability for shareowners to oversee and evaluate the audit committee's activities regarding the above referenced three best practices would likely be enhanced if information regarding the duration of the auditor's relationship with the company were disclosed. Moreover, disclosure of auditor tenure would also be useful to shareowners when seeking to develop a basis upon which to cast votes in connection with the ratification of the audit committee's selection of the external auditor. That vote, consistent with our membership approved policies,[15] is held annually at most public companies.[16]

Finally, since the auditor's report "is the primary means by which the auditor communicates with investors and other financial statement users,"[17] it seems entirely appropriate to us that certain information about the auditor that investors and other financial statement users find particularly useful, including information about auditor tenure, should be disclosed in the auditor's report.

6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?[18]

CII generally believes that the proposed auditor reporting standard requiring the auditor to describe the auditor's responsibilities for other information would not, with the exception of the reporting of the results of the evaluation, necessarily make the auditor's report more informative and useful to investors.[19] Disclosure of a largely boilerplate description of the auditor's responsibilities for other information is not, in our view, responsive to investors' information needs regarding improvements to the

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[12] *Id.*
[13] *Id.* § 2.13b Competitive Bids.
[14] PCAOB Release No. 2013-005 at A5-16.
[15] § 2.13f Shareowner Votes on the Board's Choice of Outside Auditor.
[16] *See, e.g.*, ISS Link database: link.issgovernance.com (last viewed Dec. 13, 2013) (In 2013, 2,769 of the Russell 3000 companies held a shareowner vote to ratify the choice of independent external auditor).
[17] PCAOB Release No. 2013-005 at 2.
[18] *Id.* at A5-21.
[19] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Office of the Secretary, PCAOB 17-18 (Sept. 19, 2011) (Attachment), *available at* http://pcaobus.org/Rules/Rulemaking/Docket034/015_CII.pdf [hereinafter 2011 Letter].

auditor's reporting model.[20] On this issue, we generally agree with noted analyst/investor Jack Ciesielski who recently commented:

> *[T]here's not a lot of new ground-breaking information provided to financial statement users in the report on other information. The only time it would really be of interest to financial statement users is when the auditor really has identified problems with the OFI and states so in the report. That's a situation that should be exceedingly rare; the ability of the auditor to contradict management in their own report is a powerful lever that should persuade managers to appreciate the auditor's point of view.*[21]

<u>Questions Related to Section V:</u>

10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?[22]

CII generally believes that the auditor's communication of critical audit matters would be more relevant and useful to investors and other financial statement users if the proposed communication were revised to require that the auditor communicate, at a minimum, an *assessment of management's critical accounting judgments and estimates* based on procedures the auditor performed. We generally believe that, as revised, the auditor's communication of critical accounting matters would be more responsive to investors' information needs.

Our membership-approved policies generally support the view that the auditor's report should be responsive to investor information needs and include insights from the independent external auditor.[23] Consistent with that view, the Board found that "many investors indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the auditor's report to make the report more relevant and useful."[24]

The Board also acknowledged that one of the most frequently suggested areas for additional auditor reporting by investors is "matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty."[25] We continue to believe that this area is the most common category of insights that investors consistently demand, and therefore,

[20] *Id*. at 18.
[21] Jack T. Ciesielski, 22 The Analyst's Accounting Observer 5 (Nov. 22, 2013) (on file with CII).
[22] PCAOB Release No. 2013-005 at A5-44.
[23] CII Statement on Independence of Accounting and Auditing Standard Setters 2; § 2.13b Competitive Bids.
[24] PCAOB Release No. 2013-005 at 3 (footnote omitted).
[25] *Id.* at 11.

should be required to be included in the auditor's communication of critical audit matters.[26]

11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?[27]

CII generally believes that there are many potential benefits that would be associated with the auditor's communication of critical audit matters, if the communication reflects the revision described in response to question 10. As indicated in our September 2011 Letter, in response to the Board's earlier *Concept Release on Possible Revisions to the PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("2011 Letter"), we generally believe that, consistent with our membership-approved policies, the benefits of the communication would:

> [First,] provid[e] investors with information relevant to analyzing and pricing risks and making informed investment decisions because (a) the auditor's extensive knowledge of the company and industry obtained through the audit process and the auditor's experiences with other companies in similar industries; (b) the auditor is an independent third party that could provide an unbiased view of the company's financial statements; and (c) the auditor could use the disclosure requirement to "'leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors."
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> Second … increas[e] quality competition among audit firms, particularly in the area of professional skepticism, and, thereby, enhance the value of the audit to investors and the confidence in audited financial reports.
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> Third … assist[investor/shareowners] … in their responsibilities for overseeing company directors and management. For example, information provided by the auditor providing insight into any disconnect between the company's and the auditor's assumptions would provide investor/shareowners a better sense of management, and perhaps management's willingness to engage in aggressive accounting.

[26] *See* 2011 Letter, *supra* note 19, at 1-7 (providing a basis, with supporting citations, for the view that that investors believe the standard auditor's report should be improved to provide, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates).
[27] PCAOB Release No. 2013-005 at A5-44.

> Finally … assist[investor/shareowners] … in making an informed vote on the board's choice of the external independent auditor.[28]

We generally agree with the Board that the benefits that would be associated with the auditor's communication of critical audit matters could also include:

> [F]ocusing investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making….
>
> [H]elp[ing] investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. . . . [P]rovid[ing] investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures…. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.
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> . . . [I]increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[29]

12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?[30]

As indicated in response to question 10, CII generally believes that the definition of a critical audit matter would be sufficient for purposes of providing relevant and useful information to investors and other financial statement users in the auditor's report, if the definition were revised so that critical audit matters would be required to include, at a minimum, an assessment of management's critical accounting judgments and estimates based on procedures the auditor performed.

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[28] 2011 Letter, *supra* note 19, at 9-10 (Attachment) (footnotes omitted).
[29] PCAOB Release No. 2013-005 at A5-22 to 23 (footnotes omitted).
[30] *Id.* at A5-44.

13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the financial statements? What kind of an effect on quality of the audit can it have?[31]

As indicated in response to question 11, CII generally believes there are at least four reasons why the additional time incurred regarding critical audit matters could have a positive effect on audit quality. We also generally agree with the Board that "it could increase the auditor's focus on critical audit matters, which could result in enhancing the quality of the audit."[32]

15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not? [33]

CII generally believes that including the audit procedures performed in the communication of critical audit matters in the auditor's report would not, with the exception of the reporting of the resolution of the critical audit matter, necessarily make the auditor's report more informative and useful to investors. As indicated in response to question 10, our membership-approved policies generally support the view that the auditor's report should be responsive to investor information needs and include insights from the independent external auditor. Disclosure of audit procedures performed is not, in our view, the kind of insight that would be responsive to investors' information needs regarding improvements to the auditor's reporting model.

17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?[34]

CII generally believes that, consistent with our membership-approved policies, the Board should consider adding a factor that focuses the auditor on the key customer of audited financial reports – the investor. We note that a recent independent study commissioned by the Standards Working Group of the Global Public Policy Committee indicates that the appropriate application of professional skepticism could be enhanced if standard setters infuse standards with judgment frames requiring the auditor to consider issues from the perspective of other parties, including investors.[35] Consistent with the study's results and our policies, we believe the Board should consider adding a factor requiring the auditor to consider the most significant matters in the financial statements from the point of view of a reasonable investor.[36]

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[31] *Id*.
[32] *Id.* at A5-29.
[33] *Id*. at A5-45.
[34] *Id.*
[35] *See* Stephen M. Glover et al., *Enhancing Auditor Professional Skepticism* 22 (Nov. 2013), *available at* http://www.thecaq.org/docs/research/skepticismreport.pdf.
[36] *See* Steven B. Harris, Board Member, PCAOB Open Board Meeting 1-2 (Aug. 13, 2013), http://pcaobus.org/News/Speech/Pages/08132013_Harris.aspx ("I believe we should be seriously

21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?[37]

CII generally believes that one indirect cost that the Board should take into account relating to the auditor's determination, communication, and documentation of critical audit matters is that the communication would expand the length of the current auditor's report and, therefore, make it more difficult for investors to quickly and easily identify departures from the standard unqualified report.[38] We, however, believe this indirect cost would be far exceeded by the many benefits to investors of the auditor's communication, if the communication were viewed as responsive to the needs of investors for more relevant and useful information from the auditor. As indicated in response to question 10, we believe the auditor's communication of critical audit matters would be more responsive to the information needs of investors if it is required to include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates.

25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?[39]

As indicated in response to question 10, CII generally believes that the examples in the Exhibit would provide more useful and relevant information to investors if the examples provided more information about the independent auditor's insights, including their assessment of management's critical accounting judgments and estimates based on procedures the auditor performed. More specifically, we generally believe that the illustrative examples should include, for each critical audit matter, the auditor's assessment and insights about where on a continuum of aggressive to cautious management's key judgments and estimates fall, and whether the related reported amount is within a reasonable range according to the auditor's beliefs.[40]

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considering a requirement that auditors also report on 'any matter that would otherwise be of greatest significance to a reasonable investor in understanding the import of the financial statements.'").

[37] PCAOB Release No. 2013-005 at A5-45.

[38] *See* 2011 Letter, *supra* note 19, at 18 ("the clarifications, at least in combination, would likely diminish the value of the existing auditor's report by making it more difficult for investors to quickly discern whether the report departs from the standard unqualified report").

[39] PCAOB Release No. 2013-005 at A5-46.

[40] *See* 2011 Letter, *supra* note 19, at 6-7 (describing investor survey results and a Financial Reporting Council paper supportive of greater transparency surrounding estimates and judgments); *see also* Andrew Sawers, *Suddenly, Audit Reports Get Sexy*, CFO.com, June 27, 2012, at 1, *available at* http://ww2.cfo.com/auditing/2012/06/suddenly-audit-reports-get-sexy/ ("Instead of an audit firm approving a set of accounts, signing off on them through gritted teeth after wrangling over some edge-of –the-envelope valuations pushed hard by its fee paying client, the audit firm could have the ability—in fact, the requirement—to reveal that the assumptions underlying the financial statements are far from

We also continue to generally believe that the appropriate level of detail for the disclosure "should generally be consistent with the information currently required to be communicated to the audit committee, or the information required to be included in the summary memorandum prepared by the engagement partner for the audit work papers describing the major risks of the audit.''[41]

26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.[42]

CII generally believes the challenges that might be associated with the comparability of audit reports containing critical audit matters are limited. We generally agree with those investors who have commented to the Board "that they are interested in information that is specific to the audit of a company's financial statements, and, therefore, would expect differences in auditors' reports among companies and reporting periods."[43] As we indicated in our 2011 Letter, "if the information contained in the [auditor's] reports is always consistent, the potential benefits to investors would be diminished."[44]

27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?[45]

CII generally believes that the benefits that would be associated with requiring auditors to communicate critical audit matters are, at least in part, dependent upon the required disclosure of information that otherwise would not have been disclosed under existing auditor and financial reporting standards. As indicated in response to question 11, the potential benefits of such a disclosure are many.

Proposed Other Information Standard

<u>Questions Related to Section III</u>:

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conversative, though they may just fall within what the auditor regards as an acceptable range of valuations.").

[41] *See* 2011 Letter, *supra* note 19, at 12.

[42] PCAOB Release No. 2013-005 at A5-46.

[43] *Id.* at A5-42.

[44] 2011 Letter, *supra* note 19, at 13.

[45] PCAOB Release No. 2013-005 at A5-46.

7. **Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?[46]**

CII generally believes that the evaluation of the other information would increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information. In our view, if the evaluation of the other information results in management correcting or improving the other information "to avoid potentially inconsistent or competing information between the auditor and management, *investors would . . . benefit as a result of the 'enhanced management disclosure in the financial statements, thus increasing transparency….*''[47] We, therefore, generally agree with the Board that:

> As a result of the auditor's evaluation of other information, and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information available to investors and other financial statement users.[48]

<u>Questions Related to Section VI:</u>

21. **Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?[49]**

CII generally believes that the proposed reporting, including the illustrative language, would provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. However, disclosure of a largely boilerplate description of the auditor's responsibilities for other information is not, in our view, responsive to investors' information needs regarding improvements to the auditor's reporting model.[50]

<u>Questions Related to Section IX</u>:

[4646] *Id.* at A6-22.
[47] 2011 Letter, *supra* note 19, at 14 (emphasis added); *see* Jack T. Ciesielski at 5 ("the ability of the auditor to contradict management in their own report is a powerful lever that should persuade managers to appreciate the auditor's point of view").
[48] PCAOB Release No. 2013-005 at A6-18 (footnotes omitted).
[49] *Id.* at A6-36.
[50] 2011 Letter, *supra* note 19, at 18.

27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?[51]

CII generally believes that the Board should require the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting, and that the auditor does not express an opinion on management's report. We have been long-time proponents of requiring auditors of all public companies to examine and express an opinion on management's assertion of the effectiveness of internal control over financial reporting because we believe that, among other benefits, such assurance is an important and effective "driver of confidence in the integrity of financial reporting and in the fairness of the capital markets."[52] We generally agree with the U.S. Government Accountability Office's recommendation that the proposed disclosure "could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions."[53]

Emerging Growth Companies

<u>Questions:</u>

1. Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?[54]

CII generally believes that the proposed standards and amendments, if revised in response to our comments, should be applicable for audits of EGC. We are currently unaware of any basis for excluding an EGC from the proposed standards and amendments.

We generally agree with the Board that the application of the proposed standards and amendments to EGCs would provide useful information that "could contribute

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[51] PCAOB Release No. 2013-005 at A6-43.

[52] *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors et al., to The Honorable Scott Garrett, Chairman, House Capital Market Subcommittee et al. 2 (July 31, 2012), http://www.cii.org/files/issues_and_advocacy/correspondence/2012/07_31_12_joint_CAQ_CII_letter_opposing_HR_6161.pdf (referencing, among other benefits, the U.S. Securities and Exchange Commission staff study finding "that auditor involvement in [the company's internal control over financial reporting] ICFR is positively correlated with more accurate and reliable disclosure of all internal control deficiencies that conveys relevant information to investors about the company and how it is managed").

[53] GAO, Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation, GAO-13-582 at 27 (July 3, 2013), http://www.gao.gov/assets/660/655710.pdf.

[54] PCAOB Release No. 2013-005 at A7-21.

toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital."[55] We also generally agree with the Board that "[e]xempting EGC's from the proposed standards and amendments could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a [further] competitive disadvantage compared to non-EGCs in attracting available capital."[56] We believe the Board's views are likely bolstered by the underlying data indicating that "financial institutions represent approximately 28% of the total assets of EGCs,"[57] "EGCs are 10 times more likely . . . to have a management report . . . stating that the company's internal control over financial reporting was not effective,"[58] and for "55% of the EGCs . . . there is substantial doubt about the company's ability to continue as a going concern."[59]

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[55] *Id.* at A7-19.
[56] *Id.* at A7-21.
[57] *Id*. at A7-17.
[58] *Id.* at A7-18.
[59] *Id.*