



The Association of
Accountants and
Financial Professionals
in Business

July 18, 2016

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Board Members:

This letter reflects the comments of the Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) on the May 11, 2016 Proposed Auditing Standard (Exposure Draft or ED), *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. We previously commented on the August 13, 2013 ED (FRC letter dated November 12, 2013) and the earlier Concepts Release (FRC letter dated September 22, 2011) on the same subject. We continue to appreciate the Board's objective of seeking "to enhance the form and content of the report to make it more relevant and informative to investors and other financial statement users." We are pleased that the Board has made a number of changes to its 2013 proposal to address matters raised by us and many others. However, we are concerned that the most significant aspects of the new proposal will not meet the aforementioned objectives but will cause operational and other issues for companies and their auditors.

The IMA is a global association representing over 80,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy Activity, Areas of Advocacy, Financial Reporting Committee).

Summary

Our November 2013 letter principally took issue with the proposals to (1) include Critical Audit Matters (CAM) in the auditor's report, (2) extend the auditor's report to cover "other information" outside of the financial statements, and (3) require disclosure in the report of the auditor's tenure. We are pleased that the Board has deferred consideration of the reporting on other information and has removed that topic from the new ED. The Board has also made a number of changes in what would be classified as CAMs and how they would be reported. However, we remain unconvinced that inclusion of CAMs in auditor's reports will add value relevant information for readers of those reports while such inclusion will almost certainly add cost to the audit, create operational issues, and cause problems in the management/auditor relationship.



The Board has suggested an alternative location (Form AP) as a possibility for auditor tenure information. We continue to believe this is a corporate governance matter that should be dealt with by the SEC. But including the information in Form AP would certainly be better than in the auditor's report.

In short, as spelled out in our following comments, we believe the principal components of the new ED – Critical Audit Matters and auditor tenure – would provide mainly irrelevant information to users, add unnecessary cost to the audit process, create operational issues, and create unnecessary tension in the preparation of the financial statements between management and auditors. We strongly recommend that the PCAOB convene a public roundtable with auditors, preparers and users before finalizing any auditing standard. This would provide an opportunity for a face-to-face discussion of exactly how CAMs might be used by investors as well as the identification of at least some of what we believe are apt to be numerous operational issues in application.

The remainder of this letter provides our reasoning for these positions.

Critical Audit Matters

As originally stated in our September 2011 letter responding to the Concepts Release on this subject, and as repeated in our November 2013 letter, we believe that the overall framework for the auditor reporting model should be consistent with the following principles (wording slightly revised from the original for clarity).

1. The objective of an audit should remain as we know it today. It should provide an opinion on the financial statements, not management's discussion and analysis (MD&A) or other areas of financial reporting
2. Auditors should not disclose information for which they are the original source. Rather they should opine on information provided by management.
3. The auditor's report should provide transparency for investors as to what the audit provides in terms of assurance (what it is) as well as what it does not address (what it is not).
4. Auditor involvement and attestation should be limited to areas for which they have the appropriate expertise.

The existing "pass/fail" model, carried forward in the new ED, is consistent with this framework and we continue to strongly support it. One aspect of the ED that we particularly support is the proposal to move the opinion paragraph to the beginning of the report. We believe that most readers of auditor's reports are mainly interested in whether a company has received an unqualified opinion from its auditor and putting that right up front makes sense to us.

Further, the decision to remove reporting on other information from this project, at least for now, is consistent with the first item in our suggested framework and removes concerns about some issues that would arise under the last item. And we appreciate that changes have been made that greatly reduce the incidence of disclosing information for which auditors are not the original source. However, the ED would still require the auditor to make such disclosure when necessary to describe a CAM or how it was addressed and that would violate our framework.



Notwithstanding that the ED is somewhat more consistent with our suggested framework than the approach in the 2013 proposal, it is clear to us, through the discussions in the ED and otherwise that a compelling case for the inclusion of CAMs in auditor's reports has not been made. The PCAOB argues that certain users have requested this information and certain other audit regulators have required its presentation in other jurisdictions. However, the ED simply does not provide a convincing case that investors and other users would gain valuable information about company financial reporting as a result of including CAMs in auditor's reports.

CAMs will not help in the analysis of financial statements

We noted on page 2 of the ED, "... additional reporting by the auditor could¹ facilitate analysis of the financial statements..." This theme seems to be fundamental to the Board's support for the presentation of CAMs as indicated on page 64 under Economic Considerations, "The Board believes that the communication of critical audit matters should help focus investors' and other financial statement users' attention on these matters by making them more prominent, which could facilitate their analysis of the financial statements and other relevant disclosures (emphasis added)." Further, although the ED cites user interest in CAMs (e.g., footnote 119), nowhere in the document does the Board describe how CAMs would actually be used to help "analyze financial statements."

Our 2013 letter expressed support for the Board's encouragement for companies and auditors to field test how the CAM provision would be applied in practice. Based on our reading of the new ED, the only such test was the limited implementation trial performed under the auspices of the Center for Audit Quality (see footnote 36). We commend the CAQ field test as it led to changes in the approach to CAMs, particularly limiting them to those matters reported to audit committees and including a materiality consideration. However, it appears that no other field testing was performed by the Board itself. And, most importantly, the CAQ field test apparently did not include any discussions with investors as to how they might make use of the reported CAMs.

We note that in his statement at the meeting when the 2013 ED was approved by the PCAOB, Board member Hanson stated, "I would like to encourage a dialog among audit firms, management, audit committees and investors to discuss our proposals and to foster better understanding among everyone about potential benefits and costs (emphasis added)." And in encouraging auditors to work with companies to develop example CAMs based on the then proposal he added, "Perhaps even share them with investors to obtain their views on the usefulness of the information." That critical component of field testing was absent from the CAQ study and we are not aware of any other work the Board has done to determine what investors and other users of auditor's reports would actually do with reported CAMs. We note that the FASB has worked closely with users in recent years to test how new proposals would enable more decision useful information. Without some specific evidence of how CAMs could possibly be used to help analyze financial statements, similar to an FASB field test, we believe this proposal is problematic.

¹ While we did not count, we note that the ED is replete with the use of such conditional words as "could," "might," and "may." This choice of words indicates a lack of solid evidence to support the usefulness of CAMs to investors and other readers of auditor's reports.



Based on statements made at the meeting approving the ED and otherwise, at least some Board members are anxious to complete the auditor's report project as soon as possible – perhaps as early as year-end 2016. We recognize that a great deal of research and public consideration has already gone into this project. But we believe that public roundtables at which auditors, preparers, and users (investors and analysts) would discuss exactly how CAMs would be developed and used in practice are necessary.

The Economic Considerations section of the ED does not, in our view, provide a true economic analysis of the pros and cons of mandating presentation of CAMs in auditor's reports. Rather, it consists largely of references to academic studies on the purported benefits of such presentation. And the most important point is captured well on page 74 in the following words, "Overall the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively, the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements (emphasis added)."

The two illustrative examples of communication of critical audit matters included on pages 32-35 of the ED demonstrate the lack of value relevant information that would be provided. These examples do include references to important accounting policies and/or estimates, which matters presumably have been thoroughly reported in the financial statements, footnotes, or MD&A. Those references may indeed "... help focus investors' and other financial statement users' attention on these matters by making them more prominent..." But the company already will have highlighted most, if not all, of these same matters by including them in the critical accounting policies and estimates section of MD&A. It is not clear to us that an additional notification in the auditor's report will cause investors to pay more attention to these matters.

More importantly, based on both the proposed auditing standard and the illustrative examples, we believe the remaining content of CAMs is likely to give only very generalized descriptions of auditing procedures. No information that would actually allow investors to analyze financial statements will be included. Further, we expect that the information would become boilerplate as it is overseen and managed by the accounting firms' national offices based on the respective risk areas – income taxes, fair value estimates, various accruals, etc.

For example, the following are some of the descriptions of audit procedures from the two illustrations included in the ED.

- "We tested the accuracy and evaluated the relevance of the historical loss data as an input to the new model.
- ... we evaluated the incorporation of the applicable assumptions into the model and tested the model's computational accuracy.
- ...we assessed whether ... the significant assumptions, including discount rates, estimated useful lives, revenue growth rates, projected profit margins, and the expected rate of return, used in valuing these intangibles were reasonable.
- ... we assessed the terms of the arrangements and the conditions that must be met for the arrangements to become payable."



Those descriptions might lead a reader to conclude that the auditor has found the related accounting matter to be "fairly stated," although the Board warns against such piecemeal conclusions by way of the required introductory paragraph to the presentation of CAMs in the auditor's report. Beyond that, we cannot find anything in those and the other descriptions from the illustrative examples that could possibly help readers analyze financial statements.

In speeches and at open meetings, PCAOB representatives have cited some of the auditor's reports under relatively recent UK regulations as examples of how investors would be more informed with the inclusion of CAMs. In particular, the auditor's report for Rolls-Royce Holdings plc has been mentioned as an excellent example². The 2015 report on Rolls-Royce by KPMG includes the following subjective assessments.

- We found the degree of caution/optimism adopted in estimates (re: revenue and profit guidance) to be slightly less cautious than in the previous year, but balanced overall.
- Overall the findings from across the whole audit are that the financial statements have been prepared on the basis of appropriate accounting policies, reflect balanced estimates compared to the mildly cautious estimates made last year resulting in slightly favourable current year profit recognition, and provide appropriate disclosure.

These assessments, which of course go well beyond what is called for in the ED, could conceivably help investors and other users analyze financial statements. But we understand that it is relatively rare for U.K. auditors to make these kinds of judgments. More importantly, in the heavily regulated and litigious environment in which the U.S. auditing profession operates, we expect that no firm would want to expose itself to challenges when such assessments are inevitably second guessed. In other words, what might seem like a good idea in other parts of the world is not operational in our culture and legal environment.

Rather than continuing to call for presentation of lengthy CAMs in auditor's report that have no demonstrated analytic value to investors or other users of the financial statements, the Board should take one of two steps. Our preference would be for this proposal to be eliminated from any final standard. An alternative would be to recognize one meritorious aspect of the CAMs proposal – to draw greater attention to the company's critical accounting policies and estimates. The proposed report now calls for a statement that the audit included evaluation of accounting policies and significant estimates. A single sentence could be added to state that such significant accounting policies and estimates are presented by the company on page so and so of the document in which the auditor's report is included.

We also note that investors in the larger U.S. public companies receive the benefit of an auditor's report on internal control over financial reporting. This secondary reporting provides further comfort to investors about the quality of the application of the company's accounting policies and estimates. As you know, this is not presently a common practice in many other parts of the world.

² In his remarks at a financial reporting conference sponsored by the University of Southern California on June 9, 2016, Board member Hanson stated something to the effect that the auditor's report for Rolls-Royce Holdings was the "Rolls-Royce" of auditor's reports, implying it was the best quality report he had seen.



Further, we question whether the PCAOB's concern for providing analytic information to investors exceeds the jurisdiction of the Board. We believe the PCAOB's role should be limited to oversight of auditors and should not directly involve the provision of company information or the analysis thereof to investors.

Auditor's reports should not be the original source for company information

As noted in the second point of our framework, auditors should not disclose information for which they are the original source. Rather they should opine on information provided by management. The Board has addressed this concern raised by us and others with respect to the earlier ED by proposing Note 2 to paragraph .14: "When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit."

We are concerned, however, that the "unless such information" exception may lead to many cases of company information being initially reported by the auditor or at least disagreements between companies and auditors about how certain matters should be described in auditor's reports. For example, it is quite possible to read the two illustrative examples provided in the ED and conclude that much of the information about the accounting matters in question was initiated by the auditor and would not have been required to be disclosed except for the Note 2 exception mentioned above³. We, of course, do not have complete context for these illustrations but they do raise concerns among our preparer members about which party has the principal responsibility for financial reporting including disclosures.

As we have considered this issue we have concluded that the "unless such information" exception is not necessary and should be eliminated if CAMs are included in a final standard. In any situation where an auditor has major reservations about a company's disclosures for a critical accounting policy or estimate, the auditor can always threaten a qualified opinion if the company does not improve the disclosures. In the experience of our members as both auditors and preparers, such situations are fairly rare and are always resolved relatively amicably. Thus, we urge deletion of the exception language in that Note 2 to paragraph .14 if CAMs are included in a final audit standard.

Determining which items qualify as CAMs is likely to present many operational problems

As noted earlier, we applaud the Board for making a number of changes to the earlier proposal to address comments concerning the definition and application of CAMs. In particular, limiting such matters to those reported to the audit committee and introducing a materiality consideration should help limit the number of items potentially reported and provide reasonable guidelines for includable items. However, while we have only had preliminary discussions about how the ED would be applied in practice, we are already aware of certain issues. Consider the following example.

³ A final auditing standard could address this concern by eliminating much of introductory language in the two examples and reducing it to a short reference to the company's financial statements where the matter is discussed. Or, if the PCAOB retains the Note 2 exception and wishes to include an example, it should explicitly describe such illustration as providing the information pursuant to the Note 2 exception.



The auditor for Company A has reported a significant deficiency in internal control over inventory to the audit committee. However, a compensating control exists and there is no material weakness. Inventory is material to the company. Is this item required to be reported as a CAM? The PCAOB might clarify that a significant deficiency in and of itself should not result in a CAM.

A public roundtable as suggested earlier in this letter would be a good opportunity to surface these kinds of operational issues with the ED and determine whether the proposal can be applied effectively in practice.

Requiring CAMs will distract attention of both the auditor and company during the important closing process

We repeat the following paragraph that we believe is still relevant from our 2013 letter.

“We also are concerned that the time and effort devoted to fulfilling these particular requirements could distract attention from what we consider the core deliverables of the audit and divert valuable resources of audit firms, management, and audit committees. At present, companies present their financial statements and other information for final review and signoff by the audit engagement partner, concurring partner, and often, national office SEC reviewing partner – all of this under very tight SEC filing deadlines. With a CAM requirement, the process would become more like a “simultaneous equation” as the company would have its information and the auditors would have their own version and each party would then have to enter into negotiations on which version of the description of certain significant estimates, etc. is in the CAM vs. the MD&A, footnotes, etc. This would require discussions among financial management, audit committees, internal and external legal advisors, local and possibly regional and national office audit personnel, and so on. It’s hard to understand how this can possibly be a productive use of senior audit executive time at the critical audit closing juncture.”

This concern was proven to be valid during the CAQ field test. Included in the report on that work are the following statements.

"Two additional observations related to the additional time and effort considerations are as follows:

- A majority of the additional time is likely to be incurred during the wrap-up phase of the audit, (i.e., once most of the audit work has been finalized, so that the auditor can determine what the actual CAMs are), despite efforts to start the process earlier in the audit. This could occur at a time when auditors, management and audit committees are focused on a number of other issues in connection with a particular filing, and the finalization of CAM communications may delay, or cause distractions in, the resolution of these issues.
- CAM related discussions with management and the audit committee are likely to involve senior members of the audit engagement team and may require national office consultations, thus requiring additional effort by key audit resources at the end of the audit.



Finally, many of the accounting firms expressed the view that the incremental time required may not decrease significantly in future years, given (1) that one of the stated objectives of the proposed auditor reporting standard is to avoid boilerplate descriptions and (2) the need to address new potential CAMs each year as a result of transactions or other changing business or financial reporting dynamics."

We recognize that the CAQ study was based on the definition of a CAM and other CAM related guidance from the earlier ED. Nevertheless, we believe that the findings from the CAQ study reinforce our belief that CAM related discussions are likely to result in inefficiencies in both company and auditor time during the final stages of year end reporting. Requiring auditors and companies to report on the same items albeit in a different manner inevitably will lead to greater tension between the parties.

In summary, we do not believe that CAMs would provide value relevant information for investors and other readers of auditor's reports. We are concerned that requiring CAMs to be included in such reports would increase audit costs and create operational issues and unnecessary auditor/company conflict in many cases at a crucial time of the audit. Finally, we simply do not see any support in the ED for the statement on page 3 that the identification and communications of CAMs "... may also lead to an incremental increase in audit quality..." The mission of the PCAOB is to maintain and improve audit quality but simply asserting that something could occur is inappropriate without supporting evidence or rationale.

Auditor Tenure

Our 2013 letter did not support inclusion of tenure information in the auditor's report. We briefly noted at that time the lack of association of auditor tenure with audit quality. The new ED brings forward this proposal but with little evidence to support that it would provide valuable information to investors or somehow improve audit quality. Perhaps the most telling comments in the ED are the sentences on page 91, "Academic research on the relationship of audit tenure to audit quality has varied conclusions. Some academic research concludes that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry. Other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality."

We also note and concur with concerns expressed in another sentence on page 91, "... it is possible that some investors may draw incorrect inferences about auditor tenure that could have an unwarranted effect on cost of capital and could also result in conversation that are an inefficient use of management and audit committee time."

FRC members' experience as preparers for or auditors of large, complex companies for the most part, leads us to believe that there is a significant learning process involved for those assigned as key audit personnel. So a reasonable amount of continuity is important for an audit firm to perform an effective audit. However, the mandatory partner rotation rules mean that not just one but several partners are bringing fresh looks to a major company's audit frequently. Even for the smallest public company, there



is required rotation of both the engagement partner and concurring review partner. We think this provides an appropriate balance between continuity of audit firm understanding of company operations, etc. and independence of thought from new personnel.

Given the above, we continue to believe that auditor tenure information does not give investors any real insights about auditor quality. We do note from the ED the increased voluntary disclosure of this information in proxy statements and we expect this will continue as such disclosure becomes best practice. At some point the SEC may feel it is a matter that should be reviewed as a possible requirement for proxy statement disclosures.

In the meantime, the PCAOB should drop this part of its proposal. The suggested alternative of including the information in Form AP is certainly less objectionable than including it in the auditor's report. But even that alternative should not be adopted unless the Board can demonstrate that tenure has some audit-related value rather than being connected only to the governance/auditor ratification proxy process.

In Conclusion

We support the other wording changes to the auditor's report. However, we continue to believe that a case has not been made to require inclusion of CAMs or tenure information in the auditor's report and we do not support those matters. We appreciate the opportunity to express our views on the exposure draft. Please let me know if you would like us to further explain these views or provide added information.

Sincerely,

A handwritten signature in blue ink that reads "N. Schroeder".

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