



CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS

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September 10, 2018

Ms. Phoebe W. Brown  
Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

**Re: *PCAOB Draft Strategic Plan 2018-2022* (PCAOB Release No. 2018-001,  
August 10, 2018)**

Dear Ms. Brown:

The U. S. Chamber of Commerce (the “Chamber”) created the Center for Capital Markets Competitiveness (“the CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.<sup>1</sup> The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role that external audits play in capital formation, efficient capital markets, and investor protection. The CCMC appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB” or “Board”) Draft Strategic Plan 2018-2022 (the “Strategic Plan” or “Plan”).

The CCMC is very supportive of the Board’s direction as reflected in the Strategic Plan. Over the past few years, the CCMC has provided perspective on a number of issues related to the Board’s areas of strategic focus.<sup>2</sup> This letter discusses our perspectives in the context of the PCAOB’s Strategic Plan for 2018-2022.

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<sup>1</sup> The Chamber is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information.

<sup>2</sup> For example, see the attached letters from the CCMC to the Securities and Exchange Commission (“SEC”) dated October 9, 2013 on modernization of financial reporting policies and to the SEC and PCAOB dated May 29, 2015 on issues impacting internal control over financial reporting and audits.

It is important to note that the audit profession is undergoing radical transformation driven by technological changes such as big data, artificial intelligence, machine learning, and blockchain. This technological transformation is making the process of developing and presenting the audit radically different than it has been for the past 120 years. As we have stated in other fora, the PCAOB needs to acquire the expertise and technological capabilities to keep pace with change in the profession. Furthermore, the PCAOB should better understand and modify its approaches to deal with audit transformation.

We also suggest ways to facilitate timely identification and resolution of issues from PCAOB inspections and related matters that are aligned with the PCAOB's strategic focus on strengthening its processes, including economic analysis, and enhancing transparency and accessibility through proactive engagement with stakeholders, and coordination and communication with regulators and standard setters. Specifically, we recommend that the PCAOB:

- 1. Hold a Roundtable on Audit Transformation;**
- 2. Issue a Policy Statement on Audit Judgments;**
- 3. Consider the Impact of Inspections on Businesses;**
- 4. Form a Business Advisory Group and an Audit Advisory Group;**
- 5. Establish a Financial Reporting Forum ("FRF");**
- 6. Work with the SEC and FASB to Consider the Auditability of GAAP;**
- 7. Conduct Both Pre and Post-Implementation Reviews;**
- 8. Continue to Evolve the PCAOB's Approach to Economic Analysis;**  
**and**
- 9. Share Information to Assist in the Deterrence or Detection of Financial Statement Fraud.**

As discussed more fully below, these recommendations will help create dialogue on a continuous basis and promote audit effectiveness, including the appropriate exercise of auditor judgment, to enhance investor protection, capital formation, and competition.

### **Background**

This is the first time the PCAOB has invited public comment on its areas of strategic focus. This invitation is consistent with the Board's commitment to

transparency, collaboration, and stakeholder engagement and communication.<sup>3</sup> The CCMC applauds this commitment.

The Strategic Plan articulates the PCAOB's mission, vision, and values; broadly describes the key factors affecting the PCAOB's strategic outlook; identifies the PCAOB's overarching goals; and outlines the objectives the PCAOB will seek to accomplish in support of each goal. The Plan calls for the PCAOB to:

- Drive improvement in the quality of audit services through a combination of prevention, detection, deterrence, and remediation.
- Anticipate and respond to the changing environment, including emerging technologies and related risks and opportunities.
- Enhance transparency and accessibility through proactive stakeholder engagement.
- Pursue operational excellence through efficient and effective use of [the PCAOB's] resources, information, and technology.
- Develop, empower, and reward [the PCAOB's] people to achieve our shared goals.

The CCMC believes these are reasonable goals for framing actions by the PCAOB to enhance audit quality. For example, increased transparency should result in the PCAOB sharing more information, including inspection trends and best practices. The Plan also recognizes the importance of audit quality from a global perspective. For example, the Plan indicates that the Board intends to expand the PCAOB's engagement with other audit regulators around the world.<sup>4</sup> In this regard, the CCMC encourages the PCAOB to enhance coordination with foreign regulators and standard setters to help reduce regulatory discrepancies and friction for multinational public companies.

### **Recommendations**

#### **1. Hold a Roundtable on Audit Transformation**

As mentioned earlier, the audit profession is undergoing radical transformation driven by technological changes. This technological evolution is changing the tools and talent used by the profession in developing and executing the audit. Accordingly,

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<sup>3</sup> See the Strategic Plan, pages 4, 6, and 10 and the May 17, 2018 speech by Chairman William D. Duhnke, "PCAOB Transitions for the Future," at the 2018 Deloitte/University of Kansas Auditing Symposium.

<sup>4</sup> See Strategic Plan, page 10.

the PCAOB must undergo a similar transformation to be an effective regulator during 2018-2022 and beyond.

Accordingly, we respectfully request that the PCAOB convene a roundtable of all stakeholders to discuss those issues. That discussion will help the PCAOB chart a course in a challenging environment.

## **2. Issue a Policy Statement on Audit Judgments**

The CCMC continues to support the recommendation of the Securities and Exchange Commission (“SEC” or “Commission”) Advisory Committee on Improvements to Financial Reporting (“CIFiR”) that the PCAOB should issue a policy statement on how it evaluates the reasonableness of auditor judgments on both integrated and financial statement-only audits. Specifically, CIFiR recommended that:

*[T]he PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards.<sup>5</sup>*

CIFiR also stressed that the PCAOB should look to SEC policy in evaluating the appropriateness of accounting judgments as part of an auditor’s compliance with PCAOB auditing standards.<sup>6</sup>

## **3. Consider the Impact of Inspections on Businesses**

The Plan states that the PCAOB will conduct inspection activities to facilitate more timely and relevant feedback to stakeholders, including regularly assessing its inspections approach and the supporting processes and technology.<sup>7</sup> As part of this assessment, the CCMC urges the PCAOB to consider issues from inspections that impact businesses. The impact of PCAOB inspections on businesses involves both internal control over financial reporting (“ICFR”) and financial reporting.

While ICFR is a recent focus for the CCMC,<sup>8</sup> financial reporting issues will likewise arise in the future as the PCAOB inspects audit engagements of companies implementing new Generally Accepted Accounting Principles (“GAAP”), including new GAAP for revenue recognition, leases, and credit losses. Addressing issues that arise in the context of ICFR and financial reporting requires that the PCAOB

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<sup>5</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 5.

<sup>6</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 5.

<sup>7</sup> See the Strategic Plan, page 7.

<sup>8</sup> See the attached letter from the CCMC to the SEC and PCAOB dated May 29, 2015.

communicate and coordinate with the SEC and Financial Accounting Standards Board (“FASB”), along with other stakeholders, including companies, auditors, and investors.

#### **4. Form a Business Advisory Group and an Audit Advisory Group**

The Strategic Plan affirms the Board will reassess the use of advisory groups to ensure that the PCAOB is receiving timely, relevant, and useful advice.<sup>9</sup> As part of this reassessment, the CCMC encourages the PCAOB to form a Business Advisory Group to understand the role of companies as investors, their use of investments, and the potential impact of PCAOB activities on businesses.

Dialogue with a Business Advisory Group would help the PCAOB better appreciate business operations and the unintended consequences of inspections on businesses, as well as the development and implementation of audit standards.<sup>10</sup> Further, an Audit Advisory Group would more substantively allow the expertise and experience of practicing auditors to inform the PCAOB’s activities and initiatives.<sup>11</sup>

Consistent with the Board’s strategic commitment to transparency, collaboration, and stakeholder engagement and communication, PCAOB advisory groups should abide by the same rules of procedures as required of regulatory agencies by the Administrative Procedures Act and Federal Advisory Committee Act – and be balanced in presentation and open in process.<sup>12</sup>

As part of the Board’s reassessment of advisory groups, including their structure and membership, the CCMC also suggests the Board address the disconnect between the actual functioning of the Standing Advisory Group (“SAG”) and what is indicated in the PCAOB’s June 30, 2003 Release on *Compliance with Auditing and Related Professional Practice Standards and Advisory Groups* (the “Release”).<sup>13</sup> For example, the Release calls for the SAG to make written recommendations to the Board (based on a majority voting of SAG members present in person or by video or teleconferencing) in an efficient and speedy manner and present the recommendations, including

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<sup>9</sup> See the Strategic Plan, page 10.

<sup>10</sup> For example, see the attached letters from the CCMC to the SEC dated October 9, 2013 (pages 9 and 10) and to the SEC and PCAOB dated May 29, 2015.

<sup>11</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 9. Currently practicing auditors and corporate executives are included among the many members of the PCAOB’s Standing Advisory Group. Representatives from business and practicing auditors with specific expertise have also been included on the two task forces that the PCAOB has formed to date. Neither practicing auditors nor business executives (other than executives from investment funds and investment advisors) are included on the PCAOB’s Investor Advisory Group.

<sup>12</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 9.

<sup>13</sup> PCAOB Release No. 2003-009 (PCAOB Rulemaking Docket Matter No. 004).

dissenting opinions, to the Board at an open meeting of the Board. This has not occurred. In addition, while the Board determined the first SAG Chair would be the Chief Auditor (a non-voting member of SAG); the Release does not specify whether the Chief Auditor would always serve as the SAG Chair.<sup>14</sup>

Finally, the CCMC encourages the Board to include task forces in its reassessment of advisory groups. The CCMC recommends the Board integrate task forces more fully in audit standard setting. This recommendation is consistent with the Release, which contemplates the Board will establish ad hoc task forces (which may or may not consist of SAG members) to assist PCAOB staff with the drafting of technical language.<sup>15</sup> The PCAOB has formed only two task forces, but not to assist in the drafting of auditing standards. This is a missed opportunity for bringing necessary topic-specific expertise to PCAOB audit standard setting.

#### **5. Establish a Financial Reporting Forum (“FRF”)**

Another CIFI R recommendation (that the CCMC supports) was to create an FRF with a mission to identify and propose solutions to problems before they reach the crisis stage.<sup>16</sup> This FRF would consist of the SEC, FASB, PCAOB, financial regulators, investors, and businesses. A FRF would provide a more formal and transparent forum for communication and coordination among the relevant parties to supplement the current approach of informal meetings. The FRF could also address issues involving those that arise from the PCAOB inspection process with an impact on financial reporting and ICFR.

#### **6. Work with the SEC and FASB to Consider the Auditability of GAAP**

The Strategic Plan recognizes that the PCAOB’s oversight activities – and inspections in particular – yield a significant amount of data. The Plan calls for the PCAOB to more effectively analyze and communicate these data.<sup>17</sup> As part of this commitment, the CCMC encourages the PCAOB to coordinate and communicate with the SEC and FASB to provide input on the auditability of GAAP in the development of accounting standards and disclosure requirements and provide transparency on this process.<sup>18</sup> Further, formal pre and post-implementation PCAOB reviews can provide an additional source of data to facilitate input on the auditability of GAAP.

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<sup>14</sup> See the Release, pages 11 and 12.

<sup>15</sup> See the Release, pages 6 and 7.

<sup>16</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 7.

<sup>17</sup> See the Strategic Plan, page 8.

<sup>18</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, pages 6 and 7.

## **7. Conduct Both Pre and Post-Implementation Reviews**

One Strategic Plan objective is for the PCAOB to better leverage economic and risk analysis to more effectively set standards, rules, and guidance, including post-implementation reviews of new or amended standards.<sup>19</sup> While the CCMC supports this objective, we are concerned that the Plan does not mention field-testing or other forms of pre-implementation reviews that may identify unintended consequences.<sup>20</sup>

The CCMC strongly encourages the Board to engage in appropriate and reasonable field-testing before promulgating standards, rules, and guidance, in addition to post-implementation reviews. The SEC's CIFIIR similarly recommended that the PCAOB, as a participant in the financial reporting system, conduct fieldwork, formalize post-adoption review of each significant new standard, and formalize periodic assessments of existing standards to keep them current.<sup>21</sup>

The CCMC appreciates that the PCAOB's inspection process can be a source of evidence supporting new or revised auditing standards, rules, and guidance. However, inspection data are not a substitute for field-testing. We encourage the PCAOB to better tether inspection data to the specifics of each proposal in a transparent way.

The CCMC strongly encourages the PCAOB to develop a timely and robust post-implementation review plan for the PCAOB's new standard on auditor reporting (AS 3101: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). This standard represents the most significant change to auditor reporting in the U.S. in 70 years and its implementation merits close monitoring by the PCAOB, as the SEC requires.

For example, the Commission expects the PCAOB to closely monitor the implementation of the auditor reporting standard, issue incremental implementation guidance as needed, provide PCAOB staff to respond to questions and challenges as

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<sup>19</sup> See the Strategic Plan, page 7. On April 6, 2016, the PCAOB requested comment on its first post-implementation review. The CCMC provided comments in its letter to the PCAOB dated June 30, 2016 in response to the PCAOB Request for Comment on Post-Implementation Review of Auditing Standard No. 7, *Engagement Quality Review* (April 6, 2016) (Post-Implementation Review No. 2016-01). The results of this post-implementation review are not yet publicly available.

<sup>20</sup> While due process through comment letters and other forms of input may provide some insight into unintended consequences of proposed PCAOB standards and rules, these do not substitute for field testing. Further, based on the PCAOB's rules, staff guidance is not required to be subject to the due process of public comment.

<sup>21</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 6.

they arise, and complete a post-implementation review as soon as reasonably possible, including some analysis between effective dates for critical audit matters (“CAMs”).<sup>22</sup> The PCAOB’s near-term monitoring should also consider any unintended consequences from the new standard as part of assessing the costs and benefits of this change.

## **8. Continue to Evolve the PCAOB’s Approach to Economic Analysis**

Related to the PCAOB’s objective to better leverage economic and risk analysis to more effectively set standards, rules, and guidance,<sup>23</sup> the CCMC encourages the PCAOB to strengthen its approach to economic analysis. The CCMC strongly believes in the importance of robust economic analysis before and after promulgating and implementing any standard or rule, to ensure the benefits outweigh the costs and to mitigate any unintended consequences.

The CCMC appreciates that the PCAOB has made progress on economic analysis since the Jumpstart Our Business Startups Act (“JOBS Act”) made it a necessary pre-condition for applying new PCAOB auditing standards and rules to an audit of any emerging growth company (“EGC”).<sup>24</sup> However, the PCAOB needs to continue to evolve its approach to economic analysis.<sup>25</sup>

## **9. Share Information to Assist in the Deterrence or Detection of Financial Statement Fraud**

As previously discussed, the Strategic Plan commits the Board and staff to more effectively analyzing and communicating the significant amount of data PCAOB possesses. The CCMC recommends that the PCAOB do more with the information it has accumulated to identify needs, best practices, and specific actions that it could share with auditors and preparers to assist in the deterrence or detection of financial

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<sup>22</sup> See SEC Order dated October 23, 2017 *Granting Approval of 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* (Release No. 34-81916; File No. PCAOB-2017-01), page 46. The requirements related to CAMs are effective for audits of fiscal years ending on or after June 30, 2019 for large accelerated filers, and for fiscal years ending on or after December 15, 2020 for all other companies to which the requirements apply.

<sup>23</sup> See the Strategic Plan, page 7.

<sup>24</sup> For example, see the letter dated March 20, 2014 from the CCMC to the PCAOB on the PCAOB Exposure Draft on *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor’s Report of Certain Participants in the Audit* (PCAOB Release No. 2013-009, December 4, 2013; PCAOB Rulemaking Docket Matter No. 029).

<sup>25</sup> For example, see the letter dated November 15, 2017 from the CCMC to the PCAOB on the PCAOB Supplemental Request for Comment on *Proposed Amendments Related to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard on Dividing Responsibility for the Audit with Another Accounting Firm* (PCAOB Release No. 2017-005, September 26, 2017) (PCAOB Rulemaking Docket Matter No. 042).

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statement fraud. This recommendation is consistent with the CCMC's belief that all participants in the financial reporting supply chain – particularly the PCAOB – have important roles to play in combating threats to investor confidence in the U.S. capital markets from financial report fraud.<sup>26</sup>

### Conclusion

We believe that the strategic plan comes at an important inflection point for the PCAOB and the audit profession. We believe that the adoptions of these recommendations would make the PCAOB a more effective regulator. These recommendations also seek to improve financial reporting coordination amongst the PCAOB, SEC, and FASB.

Thank you for your consideration of the CCMC's comments and suggestions.

Sincerely,

A handwritten signature in black ink, appearing to read 'TK' followed by a long horizontal flourish.

Tom Quaadman

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<sup>26</sup> See the attached letter from the CCMC to the SEC dated October 9, 2013, page 9. Also, see the recommendation by the Department of the Treasury Advisory Committee on the Auditing Profession urging the SEC (and Congress as appropriate) to provide for the creation by the PCAOB of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further the development of best practices regarding fraud prevention and detection (Final Report dated October 6, 2008; page VII:1).



CENTER FOR CAPITAL MARKETS  
C O M P E T I T I V E N E S S

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October 9, 2013

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The Honorable Mary Jo White  
Chair  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Dear Chair White:

The U.S. Chamber of Commerce (the “Chamber”) is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21<sup>st</sup> century economy. To achieve these goals, the CCMC has supported the development of robust financial reporting systems and strong internal controls to promote efficient capital markets and capital formation.

We have read with interest recent reports that the Securities and Exchange Commission (“SEC”) will step up its enforcement efforts, particularly focusing on potential accounting fraud and financial disclosure irregularities. The CCMC applauds the efforts of SEC to drive bad actors from the market place and create a level playing field for participants who operate in good faith and abide by the law. As SEC uses accounting fraud and financial reporting irregularities as a means to achieve this goal, we also believe that it is incumbent for SEC to modernize financial reporting policies to facilitate the release of relevant disclosures, reduce complexity, and achieve more efficient capital formation and competition. Accordingly, we would also respectfully request an update on the status of SEC’s implementation of the recommendations of the Advisory Committee on Improvements to Financial Reporting (“CIFiR”).

Modernization of financial reporting policies is well overdue.

In the wake of the Enron and WorldCom scandals and the subsequent passage of the Sarbanes-Oxley Act (“SOX”), financial reporting has undergone significant changes and transitions. Policy makers realized that financial reporting must keep pace with those changes. Consequently, then SEC Chairman Chris Cox formed CIFiR, which released its report and recommendations to improve financial reporting in August 2008. Unfortunately, the demands of the financial crisis diverted the time and attention of the agency from its ongoing agenda of

modernizing financial reporting. We believe that the implementation of these recommendations remains an urgent item on SEC's agenda.

Adding to the urgency of these recommendations is the pace of change in financial reporting that has taken place since the financial crisis. Among the many new legislative, regulatory, and standard-setting requirements that have influenced financial reporting in the last few years is the Jumpstart Our Business Startups Act ("JOBS Act"). This law exempts emerging growth companies ("EGCs") from new rules of the Public Company Accounting Oversight Board ("PCAOB"), unless SEC determines that those rules are necessary and in the public interest<sup>1</sup>, and allows EGCs to comply with any new or revised Financial Accounting Standards Board ("FASB") standards in the same timeframe as companies that are not issuers. Similarly, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") has profoundly impacted and exacerbated many of the issues identified in the CIFIr report.

For these reasons, it is important for SEC to adopt a comprehensive approach to modernizing financial reporting policies that includes, in addition to stepped-up enforcement, increased communication and cooperation among regulators, standard setters and stakeholders. This will reinforce SEC's efforts to drive bad actors out of the marketplace, by eliminating the complexity and ambiguity on which they thrive. In fact, the CIFIr report found that financial reporting complexity is a key driver in the disconnection between current financial reporting and the information necessary to make sound investment decisions. Since keeping a clear focus on SEC's mission to ensure that investors receive relevant decision-useful information and to promote capital formation will maximize the agency's chances of success in stamping out accounting fraud and financial disclosure irregularities, we view this as a win-win for SEC and its stakeholders.

Listed below are some of the issues and suggested solutions to improve financial reporting.

### **Issues and Proposed Solutions**

#### **Issue 1: Provide Investors with Information Needed for Sound Decision Making**

**Problem: Inconsistent definitions of materiality.**

**Solution: The SEC should supplement existing guidance and coordinate in such a way to ensure that SEC, FASB and PCAOB use a common definition of materiality.**

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<sup>1</sup> See letter from the Chamber to the SEC (October 5, 2012) that Section 104 of the JOBS Act requires an analysis and finding that new PCAOB standards and revisions must promote efficiency, competition and capital formation in order to apply to EGCs.

**Background:** FASB has defined materiality for U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) differently than the securities laws, while the PCAOB is using the definition from the federal securities laws.

PCAOB Auditing Standard No. 11 states in part:

*In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is ‘a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.’ As the Supreme Court has noted, determinations of materiality require ‘delicate assessments’ of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him ...*

FASB Concept Statement No. 8 uses the following definition: “Information is material if omitting it or misstating it *could* influence decisions that users make on the basis of the financial information of a specific reporting entity.”<sup>2</sup>

Additionally, FASB’s Invitation to Comment on Disclosure Framework (File Reference 2012-220), states that reporting entities would assess the relevance of each disclosure using the basic criterion that “information should be disclosed if it has the potential to make a difference in users’ decisions about providing resources to the reporting entity.”<sup>3 4</sup>

CIFiR recommended that the FASB or SEC, as appropriate, should supplement existing guidance to reinforce that:

*Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor; and, materiality should be judged based on how an error affects the total mix of information available to a reasonable investor, including through a consideration of qualitative and quantitative factors.*<sup>5</sup>

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<sup>2</sup> Par. QC11, Chapter 3

<sup>3</sup> FASB Invitation to Comment on Disclosure Framework, paragraph 4.5 (page 45).

<sup>4</sup> For additional insights on the issues, see “What is Materiality? SEC & PCAOB v. FASB & ASB” by Samuel P. Gunther in *Bloomberg BNA* (May 7, 2012).

<sup>5</sup> Recommendation 3.1, page 80, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

It should also be noted that the International Integrated Reporting Council (“IIRC”) and the Sustainability Accounting Standards Board (“SASB”) are creating their own concepts of materiality in attempting to develop voluntary standards of non-financial reporting and disclosure – with the SASB’s disclosures intended to be included within Management Discussion and Analysis (“MD&A”) in Form 10-K and 10-Q filings with SEC. The Chamber has written to both organizations expressing concerns that the development of these standards needs to be done with SEC and that any work in this area must conform to the definitions, usage, and enforcement of materiality as defined in the Securities Acts and their progeny.<sup>6</sup> Similarly, in testimony before the U.S. Senate Subcommittee on Securities, Insurance, and Investment the Chamber stated:

*The SEC, FASB, and PCAOB should develop standards of materiality for investors, as well as the scope of outreach to the investor community. This will provide perspective on various accounting and auditing issues such as the need for restatements on the one end, while framing the picture for input on the front end of standard setting.<sup>7</sup>*

**Problem: Information overload from multiple overlapping and sometimes contradictory reporting and disclosure requirements and standards.**

**Solution: Develop a Disclosure Framework.**

**Background:** CIFIIR recommended that SEC and FASB work together to develop a disclosure framework to, among other things:

*Integrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles. This would eliminate redundancies and provide a single source of disclosure guidance across all financial reporting standards.<sup>8</sup>*

A disclosure framework would also address issues of placement of information within audited U.S. GAAP financial statements versus MD&A which is unaudited, has safe harbors and provides forward looking information.<sup>9</sup>

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<sup>6</sup> See letters from the Chamber to IIRC (July 15, 2013) and SASB (July 26, 2013).

<sup>7</sup> See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance and Investment (April 6, 2011).

<sup>8</sup> Recommendation 1.2, page 8, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

<sup>9</sup> FASB currently has a disclosure framework project in progress and the SEC Chief Accountant announced in February, 2013 that a SEC Staff Paper on disclosure is expected to be released with roundtables planned to follow.

**Problem:** The accounting standards setters continue down the path of including the recognition, measurement, and disclosure of more fair values and accounting estimates that require judgment and, therefore, investors and others cannot expect there to be a single “right answer” in accounting and auditing matters.

**Solution:** Issue a policy statement articulating how SEC evaluates the reasonableness of accounting judgments.

**Background:** CIFIIR recommended that:

*The SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. ... We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers' accounting judgments.<sup>10</sup>*

**Solution:** The PCAOB should issue a policy statement on how it evaluates the reasonableness of audit judgments.<sup>11</sup>

**Background:** CIFIIR recommended that:

*[T]he PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB's statement of policy should acknowledge that the PCAOB would look to SEC's statement of policy to the extent that the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.<sup>12</sup>*

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<sup>10</sup> Recommendation 3.5, pages 13-14, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

<sup>11</sup> See various CCMC comment letters including to the PCAOB on Request for Public Comment on Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards and Notice of Roundtable (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 34).

<sup>12</sup> Recommendation 3.5, page 14, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

**Solution: The SEC work with the FASB and PCAOB to consider the auditability of GAAP when developing accounting standards and disclosure requirements.**

**Background:** Again in testimony before the U.S. Senate Subcommittee on Securities, Insurance, and Investment the Chamber stated:

*A formal, ongoing, and transparent dialogue should be created to consider the auditability of accounting standards. This would allow for the auditing of accounting standards to work in conjunction with standard development. It would also provide for the identification and resolution of issues that arise in practice. A similar process should be created to ensure that regulators have an understanding of standards and that different entities are not working at cross purposes. The era of “not my problem” needs to end.<sup>13</sup>*

**Solution: Conduct formal pre and post-implementation reviews.**

**Background:** CIFIIR recommended that the Financial Accounting Foundation (“FAF”), FASB, and other participants in the financial reporting system:

*Enhance the consistency and transparency of key aspects of FASB’s field work, including cost-benefit analyses, field visits, and field tests.*

*Formalize post-adoption reviews of each significant new standard to address interpretive questions and reduce the diversity of practice in applying the standard, if needed.*

*Formalize periodic assessments of existing accounting and related disclosure standards to keep them current.<sup>14</sup>*

The Chamber reinforced this notion by stating that standards should be field tested and put through a rigorous process to identify unintended consequences before implementation and after implementation.<sup>15</sup>

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<sup>13</sup> See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance and Investment (April 6, 2011).

<sup>14</sup> Included in recommendation 2.3, page 11, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

<sup>15</sup> See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance, and Investment (April 6, 2011).

The Chamber appreciates that the FAF and FASB are moving in the direction of this recommendation and we suggest that the PCAOB should do likewise and that SEC should ensure that the FASB and PCAOB are coordinated in these efforts.

## **Issue 2: Increase Communication and Coordination amongst Regulator and Standard Setters**

**Problem: Lack of transparent communication and coordination among regulators, standard setters and market participants.**

**Solution: Establish a Financial Reporting Forum (“FRF”).**

**Background:** CIFI<sup>16</sup> recommended the creation of a FRF, made up of the SEC, FASB, PCAOB, financial regulators, investors (broadly defined), and businesses, with a mission to identify and propose solutions to problems before they reach the crisis stage. A FRF will also provide a mechanism to allow for appropriate coordination amongst regulators and input from investors and businesses.<sup>16</sup> It should also be noted that in the 111<sup>th</sup> Congress, the House of Representatives passed a version of H.R. 4173, the precursor bill of the Dodd-Frank Act, which contained an amendment by Rep. Gary Miller to create an FRF.

**Problem: Potential expectation gap created by the PCAOB’s recent definition of an audit failure.**

**Solution: Through the exercise of SEC’s oversight authority over the PCAOB reestablish the long-standing definition of an audit failure.**

**Background:** Several years ago and without explanation, the PCAOB began describing Part I deficiencies as audit failures in inspection reports for annually inspected firms (although the PCAOB does not use these terms in inspection reports for tri-annually inspected firms). This change in definition contradicted the long-standing and widely used definition of an audit failure as used by the Government Accountability Office (“GAO”). GAO defined audit failures as:

*[A]udits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud, and reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was not conducted in accordance with generally accepted auditing standards, and, therefore, the auditor failed to appropriately detect and/or deal with known material misstatements by (1) ensuring that*

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<sup>16</sup> See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance, and Investment (April 6, 2011).

*appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC.*<sup>17</sup>

In other words, for example, differences of opinion in the exercise of judgment on audit procedures or other audit deficiencies – which do not occur in conjunction with any material misstatement of the financial statements – could not be considered an audit failure.

You will also find with this letter, as an attachment, a letter sent by the Chamber to PCAOB Chairman James Doty that contains a more robust discussion of our concerns on the failure to properly define audit failure, the communication, and portrayal of inspections findings and how it may undermine public confidence in financial reporting.

### **Issue 3: Reduce Fraudulent Financial Reporting**

**Problem: Lack of a comprehensive and holistic approach to understanding fraudulent financial reporting, diagnosing its root causes and detecting fraud through the application of useful and appropriate methodologies and technologies.**

**Solution: Establish a Fraud Center.**

**Background:** The Advisory Committee on the Audit Profession (“ACAP”) recommended:

*SEC and Congress, as appropriate, provide for the creation by the PCAOB of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.*<sup>18</sup>

Financial reporting frauds undermine investor confidence in the capital markets. In October 2010, the Center for Audit Quality (CAQ) formally joined forces to form an Anti-Fraud Collaboration with Financial Executives International, The Institute of Internal Auditors, and the

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<sup>17</sup> See GAO 04-217 Public Accounting Firms Required Study on the Potential Effects of Mandatory Audit Firm Rotation (2003) page 6.

<sup>18</sup> ACAP Final Report (October 6, 2008), page VII:1

National Association of Corporate Directors to develop thought leadership, awareness programs, educational opportunities, and other related resources specifically targeted to the unique roles and responsibilities of the primary participants in the financial reporting supply chain. The projects and activities under this Anti-Fraud Collaboration are designed to enhance awareness and understanding of factors that contribute to financial reporting fraud, as well as strengthen the abilities of all applicable parties' efforts to deter and/or detect financial reporting fraud. These types of private sector initiatives can lead to long term progress in combating threats to investor confidence in the U.S. capital markets.

Since fraud can never be completely prevented, efforts to combat fraud must be continuous. All key participants in the financial reporting supply chain – preparers, audit committee members, auditors, *and regulators* – have important roles to play with regard to deterring and detecting financial reporting fraud. We believe the PCAOB can and should do more with the information it has accumulated through its various programs to identify trends, best practices, and specific actions that could be shared with auditors and preparers to assist in the deterrence or detection of financial statement fraud.

#### **Issue 4: Increase Transparency and Accountability of FASB and PCAOB**

**Problem: Neither the FASB nor the PCAOB are formally subject to the traditional regulatory provisions for accountability and transparency.**

**Solution: Both the FASB and PCAOB and their attendant advisory groups should abide by the same rules of procedures as required of regulatory agencies by the Administrative Procedures Act and Federal Advisory Committee Act, including any advisory groups should be balanced in presentation and open in process.<sup>19</sup>**

**Solution: The PCAOB should form a Business Advisory Group to understand the role of companies as investors, their use of investments, and the potential impact of standard setting on businesses. The PCAOB should also establish an Audit Advisory Group to more substantively bring the expertise of practicing auditors to inform the PCAOB's activities and initiatives.<sup>20</sup>**

**Background: For example, a Business Advisory Group would provide the PCAOB another means of input and broader understanding of issues that need to be addressed in the development of standards and other means of resolving important issues related to audited**

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<sup>19</sup> See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance and Investment (April 6, 2011).

<sup>20</sup> Ibid.

financial statements. This dialogue could help the PCAOB better appreciate business operations and the unintended consequences that may impact businesses through the development and implementation of accounting and auditing standards. The avoidance of adverse outcomes for businesses is critical to protect the investors who invest in them.<sup>21</sup>

#### **Issue 5: Addressing the needs of Private Company financial statement users**

**Problem: Private company financial statement users have differing needs and find public company U.S. GAAP to be too complex and burdensome.**

**Solution: Preserve U.S. GAAP as the accounting language, while empowering the Private Company Council to address the needs of private company users.**

**Background:** Any modernization of financial reporting policies requires that the differing needs of users of the financial statements be considered and addressed. In particular, privately held users do not require the same information as users those entities that are owned by the public. It is imperative that any changes made to standards do not have the unintended consequence of requiring privately held entities to follow standards which may provide information critically important to users of publically held entity financial statements but which is not relevant to their users. While CIFIr did not address these issues, following extensive study and research, the Blue Ribbon Panel on Standard Setting for Private Companies (“Blue Ribbon Panel”) made several recommendations which eventually led to the creation of the Private Company Council under the auspices of the FAF. Additionally, Congress, in passing the JOBS Act, made the public policy decision that users of financial reports are not monolithic and different business structures (ie. public company, emerging growth companies) will dictate the needs of financial statement users. Accordingly, we believe the SEC, FRF, and FAF should closely monitor the activities of the PCC to ensure the needs of private company users are met and that the Congressional intent of the JOBS Act is fulfilled.

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This is not an exhaustive list of reforms or issues that should be addressed. Rather, we view this as a starting point of discussion and would respectfully request to meet with you to discuss these ideas and proposals in greater depth and detail. While we know and appreciate the workload of SEC, it is our belief that the many changes in financial reporting over the past decade require a response to prevent disharmony in financial reporting that can adversely impact the capital markets, businesses and the investors who provide them with the resources to grow and operate on a daily basis.

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<sup>21</sup> See CCMC letter to Martin F. Baumann (May 10, 2013).

The Honorable Mary Jo White  
October 9, 2013  
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Thank you for your consideration of these views, and we look forward to further discussion with you and SEC staff as well as an update on the implementation of the CIFiR recommendations.

Sincerely,

A handwritten signature in black ink, appearing to be 'TK' followed by a long horizontal flourish.

Tom Quaadman

cc: The Honorable Luis A. Aguilar, U.S. Securities and Exchange Commission  
The Honorable Daniel Gallagher, U.S. Securities and Exchange Commission  
The Honorable Kara Stein, U.S. Securities and Exchange Commission  
The Honorable Michael Piwowar, U.S. Securities and Exchange Commission  
Mr. Paul Beswick, U.S. Securities and Exchange Commission  
Mr. Russell Golden, Financial Accounting Standards Board  
Mr. James Doty, Public Company Accounting Oversight Board  
The Honorable Tim Johnson, U.S. Senate  
The Honorable Michael Crapo, U.S. Senate  
The Honorable Jeb Hensarling, U.S. House of Representatives  
The Honorable Maxine Waters, U.S. House of Representatives  
The Honorable Scott Garrett, U.S. House of Representatives  
The Honorable Carolyn Maloney, U.S. House of Representatives



CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS

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May 29, 2015

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Chief Accountant  
Office of the Chief Accountant  
United States Securities  
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James R. Doty, Esq.  
Chairman  
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1666 K Street, NW  
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Dear Mr. Schnurr and Chairman Doty:

The U.S. Chamber of Commerce (“Chamber”)<sup>1</sup> created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21<sup>st</sup> century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The CCMC has a Financial Reporting Working Group (“FRWG”) that consists of representatives from other trade associations and a large number of companies of all sizes and a broad set of industries. The FRWG considers matters of common and general interest related to financial reporting and reporting on the effectiveness of internal control over financial reporting (“ICFR”) under Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”).

Accordingly, we respectfully request a meeting of stakeholders to jumpstart a dialogue between the business community, Public Company Accounting Oversight Board (“PCAOB”) and the Securities and Exchange Commission (“SEC” or “Commission”) in order to address issues impacting internal controls and audits that may erode judgment and impair capital formation.

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<sup>1</sup> The Chamber is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are users, preparers, and auditors of financial information.

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First, thank you both for meeting with the FRWG this past February to discuss issues regarding internal controls and external audits. The business community believes that strong and effective internal controls and audits are an important component of the ability of businesses to communicate with investors in order to raise the capital needed to operate, grow, and compete. High standards and superior performance systems are essential for management, regulators and the audit profession to execute their responsibilities and for financial reporting to meet its intended purpose. However, developments over the past several years have raised concerns that the unintended consequences of the PCAOB inspection process and corresponding changes to internal control processes are eroding judgment, as well as increasing costs and burdens for work that may in some instances not lead to more effective audits or controls. While accelerated filers are feeling the direct impacts, even non-accelerated filers are being affected.

We believe that this is the result of a lack of a dialogue between the business community and the PCAOB. Accordingly, we would respectfully request a meeting of stakeholders, the PCAOB and SEC to discuss these issues, explore ways to address them, and create such a dialogue on a continuous basis in order to promote effective controls and an appropriate exercise of judgment to enhance investor protection, capital formation, and competition.

In our view, such a meeting should focus on three areas: management review controls, a “checklist” or “one-size-fits-all” approach, and materiality. To stimulate this discussion, this letter, based on companies’ experiences, provides a context for the current environment and gives an overview of concerns in each of these three areas.

## **1. Background**

Since 2002, the business community, the SEC, and the PCAOB have implemented provisions of SOX to improve financial reporting by creating a system for assessing the effectiveness of ICFR under Section 404. In addition, the PCAOB has implemented a robust inspection program for public oversight of the firms and individuals providing external audits for public companies—both integrated audits of the financial statements and ICFR, as well as audits of the financial statements only.

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As audited financial statements are a crucial device to communicate with investors and raise capital, companies are strong supporters of internal controls. However, this road has had its ups and downs. Initially, the costs of implementing Section 404 were expensive and burdensome for companies generally. These costs and burdens were also regressive as they disproportionately increased inverse to the size of a business. Nonetheless, over the course of time and with efforts by the SEC and the PCAOB, particularly in 2006 and 2007, costs and burdens stabilized and improvements to financial reporting had a positive impact. For example, non-reliance financial restatements were at a high of 977 in 2005, and steadily declined to 255 in 2012.<sup>2</sup>

#### **a. Rationalizing the Implementation of Section 404**

The efforts by the SEC and PCAOB nearly a decade ago included the issuance of interpretive guidance for management reports on ICFR (“management guidance”) and replacing PCAOB Auditing Standard (“AS”) 2 with AS 5 for audits of ICFR integrated with financial statement audits.<sup>3</sup> Under the SEC’s 404 implementation rules, management discloses its assessment on whether the company’s ICFR is effective at fiscal year-end. Management needs to have a reasonable basis for its ICFR disclosures. The SEC’s interpretive guidance is intended to help management do so.

The purpose of issuing management guidance and AS 5 was to rationalize the planning and conduct of the ICFR evaluation process and audits of ICFR—for all companies, regardless of size. The SEC and PCAOB were committed to allowing management and auditors to get “out of the weeds” and focus on what matters most.

The SEC and PCAOB recognized that assessing and attesting to the effectiveness of ICFR is all about risk and materiality. For example, the SEC’s management guidance is intended to allow companies to focus their efforts on those areas that management identifies as posing the greatest risks of material misstatements in the financial statements

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<sup>2</sup> Center for Audit Quality, *Financial Restatement Trends in the United States: 2003-2012* by Professor Susan Scholz.

<sup>3</sup> See Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act [Release Nos. 33-8810; 34-55929; FR-77; File No. S7-24-06] effective June 27, 2007 and PCAOB Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements and Related Independence Rule and Conforming Amendments (PCAOB Release No. 2007-005A, PCAOB Rulemaking Docket Matter No. 021), approved by the Commission on July 27, 2007 [Release No. 34-56152; File No. PCAOB-2007-02].

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not being prevented or detected on a timely basis. The SEC appreciated that this is what investors care about and what is important for achieving reliable financial reporting.

The SEC's guidance is supposed to allow management to exercise significant and appropriate judgment in designing and conducting an evaluation that is tailored to the company's individual facts and circumstances. It is worth noting that under SEC guidance prior to SOX, management is responsible for maintaining a system of internal control that provides *reasonable assurance* regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP). The "reasonable assurance" referred to in the SEC's rules implementing Section 404 relates to similar language in the Foreign Corrupt Practices Act of 1977 ("FCPA").<sup>4</sup> Exchange Act Section 13(b) (7) defines "reasonable assurance" and "reasonable detail" as "such detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."<sup>5</sup> The Commission has long held that:

"[R]easonableness" is not an "absolute standard of exactitude for corporate records." In addition, the Commission recognizes that while "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules. Thus, the terms "reasonable," "reasonably," and "reasonableness" in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.<sup>6</sup>

The SEC also recognizes that reliable financial statements come from control systems that provide reasonable assurance. Control frameworks such as COSO 1992 and COSO 2013 explain what is required of a system to achieve reasonable assurance, unlike the SEC's management guidance and the PCAOB's auditing standards, including AS 5, which do not.

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<sup>4</sup> Title 1 of Pub. L. 95-213 (1977).

<sup>5</sup> See 15 U.S.C. 78m(b)(7).

<sup>6</sup> See SEC management guidance (p. 3). The SEC's management guidance also discusses that the conference committee report on the 1988 amendments to the FCPA note that the standard "does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance" (p. 3).

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Therefore, spending inordinate amounts on audits does not promote investor protection or provide the basis for an effective and sustainable system of controls. ICFR audits can only help assure that management's disclosures are materially correct. The SEC staff worked closely with the PCAOB on coordinating their respective sets of guidance to ensure that there was *not* an expectation that controls needed to be designed and tested to fit the audit—rather the audit should be planned and conducted to fit the controls.

To improve the implementation of Section 404, the SEC's management guidance and AS 5 are aligned. Both sets of guidance are principles-based and intended to provide for the exercise of judgment by management and auditors under a top-down, risk-based approach to management assessments and auditor attestation of ICFR, respectively. In describing this approach, the guidance includes the role of entity-level controls in assessing financial reporting risks and the adequacy of controls.

Along with providing for effective ICFR assessments and attestation, the respective sets of guidance for management and auditors are intended to promote efficiency. For example, the SEC's interpretive guidance states:

The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR. Rather, management can focus its evaluation process and the documentation supporting the assessment on those controls that it determines adequately addresses the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.<sup>7</sup>

To summarize, "reasonable assurance" is the foundation of SEC requirements that registrants maintain adequate books and records and systems of internal controls. Reasonable assurance is also the foundation of the COSO 1992 and 2013 frameworks

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<sup>7</sup> See the SEC's interpretive guidance for management, pp. 4-5.

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and the SEC's interpretive guidance for management on evaluating the effectiveness of ICFR.<sup>8</sup>

Companies are passionate about supporting the goal of high quality financial reporting and recognize the contributions of effective systems of ICFR to achieving this goal. In this regard, companies appreciate the role of effective audits and the PCAOB inspection process. In addition, companies do not decide what auditors need to do for their audits.

However, balance is essential and it is reasonable to expect that companies understand why certain audit activities take place. It is problematic to expect companies to support apparent excessive compliance activities that are not understood and where the costs clearly exceed the benefits. Additionally concerning is the apparent retrenchment on the rationalization of the implementation of SOX Section 404. In the current environment, from a company perspective, principles-based guidance, such as the SEC's guidance for management and COSO, has not been able to withstand the authoritative weight of new interpretations of AS 5 for auditors from PCAOB inspections and the goal of both audit firms and individual auditors to reduce the risk of inspection findings.

We appreciate the opportunity to discuss how to obtain the right balance in the current environment based on the foundational concept of reasonable assurance, along with materiality and the principles of SEC management guidance and AS 5 for top-down, risk-based approaches to ICFR assessment and attestation.

## **2. Specific Concerns**

This section summarizes some of the concerns identified by the business community that have arisen in the current environment in three areas: management review controls, a "checklist" or "one-size-fits-all" approach, and materiality. To better understand the nature of the concerns and explore feasible options for addressing them, a sample of experiences of companies are presented in bullet-point format and described

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<sup>8</sup> PCAOB auditing standards require that the auditor must plan and perform the ICFR audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment. In an audit context, reasonable assurance is defined as a high, but not absolute, level of assurance.

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“in their own words.” While the experiences reflect some variability, there is nonetheless consistency across them on the overarching need to obtain the right balance in the current environment.

#### **a. Management Review Controls**

As discussed in the background section of this letter, a focus on entity-level controls is an important element of the top-down risk-based approach emphasized in the SEC’s management guidance and AS 5. Unfortunately, the ability of companies (and auditors) to rely on entity-level controls, including management review controls, has become a challenge in the current environment. This is particularly problematic because management review controls are critically important to companies for addressing the risks of material misstatements in financial statement amounts and disclosures. Thus, what is actually most important to companies is now being deemphasized. Several factors are contributing to this situation. The following are illustrative of some of the experiences and concerns of companies regarding entity-level controls, particularly management review controls:

- Expectations around the evaluation of control design have moved well beyond the guidance in AS 5 and are not in line with risk associated with the control. The overall direction appears to be deemphasizing the risk-based approach and appropriate reliance on entity-level controls that were introduced as part of AS 5. Indeed, it appears that the audit industry has taken a step back to auditing exhaustively the process level controls and has made the bar so high for reliance on entity level controls that they are being scoped out of the framework. It appears that practice is moving gradually back to AS 2 as a result of the PCAOB inspection process.
- Requirements for documentation and levels of precision around management review controls are increasing without regard to the underlying control environment. Auditors are pushing for all review controls to have specified precision (quantitative thresholds) and no qualitative measures can be relied upon because they are not evidenced as clearly as quantitative measures. This takes any judgment or knowledge out of the process and causes companies to focus time and effort documenting their review controls to pass the audit tests rather than focusing effort on

the type of review that would most benefit the control environment. Further, it appears that all testing of management review controls (e.g., analytical reviews) must be the same (and fully documented) regardless of risk and the auditor's familiarity and historical experience with the process.

- Most of the work related to gathering additional evidence of review controls has been non-value added. As a result, companies are adding more process level controls around transaction processing since these are easier to evidence and test by auditors. However, review controls are what companies rely upon. And, a major part of a system of internal control is to have experienced, qualified finance professionals that have the skills to review and question transactions and results.
- Auditors appear to have a bias to exclude review controls where possible and/or encourage the addition of control activities that eliminate business judgment. Auditor control testing methodology and acceptable audit evidence does not appear to adjust for internal control components beyond control activities. Even though AS 5 states that the auditor can employ a mix of approaches, the audit firm's "review control" guidance states that the approach and evidence should be the same for all types of controls, irrespective of control objective.
- Significant growth in key controls has occurred specific to control activities in contrast to other COSO components and driven by increased pressure from auditors to have controls operating at the lowest level of precision rather than appreciating the assurance received from the broader integrated framework. Over-reliance by the auditor on control activities is also counter-productive to the value of implementing COSO 2013.
- Adding lower level or other key controls and testing by auditors has several other implications for companies. For example, companies end up supporting the increased work of the auditors related to additional testing and documentation requirements for these controls (e.g., walkthroughs, flowcharts, increased sample sizes and related furnishing of documents, discussions, etc.). This additional work requested of the company is significant.

- The auditors required “the review of offer letter data entry” as a key control rather than relying on seven existing key controls operating at a range of precision (e.g., journal entry review, cost center/salary reconciliations, multiple meetings/department review controls/group/business unit headcount and spending analysis, country level flux analysis etc.) In addition, the company experienced an increase in auditor designing controls and/or architecting control language to facilitate a one-for-one mapping of risk to control.
- 20% of the company key controls classified as monitors, information and communication, and risk assessment were not acknowledged or evaluated as part of the overall design assessment by the auditors. Yet, these control components provided valuable assurance over critical financial statement risks as part of the overall control framework.

*i. Documentation Issues Related to Management Review Controls*

- The PCAOB inspection process requires auditors to document the “precision” of every significant judgment, decision, or review procedure performed by the company’s personnel performing or reviewing the controls over an account. In reality, it is a very time consuming and potentially impossible task to document every complex judgment made by experienced personnel when performing or reviewing controls. What is most important is the competency of the personnel making these judgments. Moreover, without this documentation, even if control and substantive audit results show an account has no errors, the auditor is not allowed to conclude that the controls within the account operated, or the judgment of the personnel performing the controls was competent. It does not appear that auditors are allowed to exercise their own professional judgment, as PCAOB inspectors conclude that if something is not documented, it did not occur. As a result, companies and auditors spend an extensive amount of time attempting to document every judgment and decision made in complex accounts to avoid having auditors receive PCAOB inspection comments. In turn, auditors end up focusing on documentation rather than substance.

- Auditors are aggressively challenging the effectiveness of management review controls through documentation requirements. This has become especially difficult and time consuming in an electronic (paperless) environment. In turn, companies have to meet these extensive documentation requirements for reliance on controls classified as management review and for reliance on reports produced by computer applications (known as "electronic audit evidence" (EAE)). An added consideration is that companies have had to spend resources to train personnel in order to implement these new documentation requirements.
- Documentation requirements to prove robust reviews have taken place are exceptionally time consuming. Sign-off or approval is no longer sufficient—comments about the details or tick marks evidencing a “number” or “fact” have been considered as being used to conclude whether a review has been performed. In an electronic/paperless environment this is even more time consuming, and the company reverted back to documentation style from the early years of SOX.
- In 2013, the auditors established a prescribed 3-page framework document for how review-based controls need to be defined and evidenced by the company. This resulted in an unplanned impact of approximately 500 hours across the company to document a prescriptive set of criteria for how reviews occur, and to remove professional experience and judgment expected in a review. This also illustrates the emphasis being placed on designing checklist controls and formulaic driven judgment.
- The company had not entered into a new inventory supply agreement since 2010. The auditors requested that the company go back and find emails or other support to demonstrate the contract was reviewed at a proper level of precision by the proper individuals of the company. This is an example where the company pushed back—how does this demonstrate that controls are designed and operating effectively in fiscal year 2015? Nonetheless, these are the kind of requests companies are receiving from auditors.

- The company has certain liability accounts that require significant judgment. As part of our SOX control process, management meets on a quarterly basis to discuss the assumptions and review the appropriateness of the liability balances. Although we previously did not document meeting minutes, this meeting is evidenced by a comprehensive presentation document that is discussed during the meeting. The auditors have asked that we now document the meeting minutes or if that was not feasible, they suggested the auditors could attend the meeting as evidence of what was being discussed. We do not believe that documenting meeting minutes would be value-added as the meeting itself accomplishes the control objective, which is ensuring that the liability balances are appropriately stated. We also would prefer not to include the auditor in the meeting as we want to ensure a safe environment where everyone feels comfortable speaking openly. Documentation of minutes at the granular level that is now required is non-value added.

***ii. Training of Company Personnel to Adequately Perform and Document Management Review Procedures***

- In order to prepare the company's accounting staff to adequately document management review (and EAE) procedures in accordance with the external auditor's new documentation requirements, the company had to conduct an elaborate training program. This training involved compiling a 25-page set of instructions with examples of what the auditors expected for management review (and EAE) documentation; distributing these instructions to approximately 50 accountants throughout the company; and providing webinar and in-person training sessions to explain expectations and answer questions. This training was conducted such that two detailed matrices for each of the accounting processes could be prepared (one for management review controls and the other for EAE used in those controls). These comprehensive matrices (consisting of 19 columns of information per control with 230 rows of data for the management review matrices and 17 columns of information with 360 rows of data for the EAE matrices) were prepared to supplement the company's process narratives and provide the required documentation for these items to the external auditors. These matrices now need to be updated each year.

Management estimates that the manager of accounting internal controls spent 600 hours on these tasks; in addition, it took about 1,500 hours for the matrices to be completed by the accountants. None of these changes improved the underlying quality of the review.

**b. “Checklist” or “One-Size-Fits All” Approach**

*i. For ICFR Documentation*

- Process narratives (memoranda) are no longer sufficient. Auditors are requiring flow charts to supplement process narratives for all significant areas. In turn, process narratives are required to include a level of detail more akin to the documentation requirements circa AS 2 (10 years ago). For example, auditors are requesting supporting documentation for every aspect outlined in a process narrative regardless of whether it is key or not.
- Citing PCAOB inspection reports, the auditor requires a fully documented re-articulation of the process, a test of “one for all” processes and controls regardless of risk, and documentary evidence beyond documenting what is required for the test of control.
- The auditors utilize specific templates for their walkthrough documentation to ensure that all PCAOB inspection points of focus are addressed. These templates are time consuming to complete and do not contribute to the overall value of the process walkthrough in a significant manner. In addition, the company was required to use these walkthrough templates for the walkthroughs it performed on the external auditor’s behalf.

*ii. Regardless of Risk*

- Inspection results are driving auditors to perform a similar scope of procedures for lower risk accounts (that have little judgment and complexity) as for higher risk accounts (that involve significant judgment and complexity). Accounts are either “in-scope” or “out of scope.” If in-scope, all accounts appear to be tested with the same level of procedures in order to avoid PCAOB inspection findings.

- The auditors are required to treat multiple locations (e.g., regions of the country) as separate populations. This requires separate sample selections for each location, even if the accounting policies, processes, and systems are the same across all locations.
- Auditors have been required to significantly reduce their reliance on work performed by internal auditors. Despite the fact that both internal and external auditors typically report directly to the audit committee, external auditors are now required to re-perform work done by internal audit. The conclusion not to rely on the work of internal audit is not based on the merits of the facts and circumstances of the particular company but rather is a rule that applies across the board to all companies.<sup>9</sup>
- PCAOB inspection results appear to focus on “hot topic” areas without acknowledging that an account can be high risk for one company, but low risk for another. For example, even revenue in companies with non-complex, automated revenue processes can have a much lower risk profile. However, as revenue is viewed as a “hot topic” in PCAOB inspections, auditors are not allowed to apply professional judgment on the extent of procedures performed. Thus, extensive time is spent on an account with inherently low risk by auditors and by the company personnel providing information to the auditors. Other “hot topic” areas include related party transactions, defined benefit pension plans, investment valuations, inventory write-downs, fixed assets, business combinations, intangibles, and multi-location audits.

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<sup>9</sup> We note that AS 5.19 states: “The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.”<sup>10</sup> In promulgating AS 18, the PCAOB changed the language in AU 333.06.1 on Management Representations from matters including: “Information concerning related-party transactions and amounts receivable from or payable to related parties” to: “Information concerning related party transactions and amounts received from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm’s-length-transaction.”

***iii. Use of Checklists and Templates***

- PCAOB inspection results frequently focus on minute defects, departures from audit methodology, or lack of persuasive documented evidence within an account without regard to whether or not the account is a high risk account for the company. As a result, audit firms have developed extensive forms to facilitate quality assurance. Completion of these forms has increased audit hours for many accounts by more than 100%. However, the focus of these hours is on documentation and not substance or risk.
- The audit team spends a significant amount of time completing templates or checklists based on the firm's documentation standards. This distracts the team from having time to fully understand the business and determine if the disclosures or controls are material/key or a risk area to our company. Standard templates and procedures appear to have replaced auditor judgment. A key area is around significant estimates (fair value estimates) and disclosure requirements. This leads to having to respond to multiple inquiries from various audit members on the same questions. The extensive documentation also detracts from the audit staff learning accounting and auditing skills. There is so much focus on documentation and testing of controls that the staff is not generally getting exposure to how transactions are accounted for.

***iv. Related Party Transactions***

- PCAOB AS 18 is effective for audits of fiscal years beginning on or after December 15, 2014. It covers related party transactions, significant unusual transactions, and amendments to other auditing standards, including changes to management's representations to the auditor on a quarterly and annual basis.<sup>10</sup> In implementing AS 18, auditors are now asking companies to provide them with a list of the names of all related parties (even if the

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company has no related party transactions) and also that there are no side agreements or other arrangements (oral or written) undisclosed to the auditors. Given the GAAP definition of related parties, companies are facing challenges in putting together a complete list of related parties and side agreements. For example, companies are being told to identify all entities in which a member of management controls, or has significant influence over, or serves in a leadership role. Board members are also scoped into this listing and companies are facing challenges in being able to identify all family members who might control or influence.<sup>11</sup>

Furthermore, auditors are now asking management to represent: “We have made and caused the company to make available to you the names of *all* related parties and *all* relationships and transactions with related parties;” that “transactions with related parties...and information concerning these transactions and amounts have been made available to you,” and “there have been *no* side agreements or other arrangements (oral or written) undisclosed to you.” This is a big change from the previous language used by the auditors in management representation letters in which auditors asked whether: “Significant transactions with related parties...have been properly recorded and disclosed in the consolidated financial statements.” The new language loses sight of the fact that GAAP requires disclosures of *material* related party transactions (other than compensation arrangements, expense allowances, other similar items in the ordinary course of business, and transactions eliminated in the preparation of consolidated or combined financial statements (ASC 850-10-50-1)—with an objective of disclosing related party transactions that would make a difference in users’ decision-making (ASC 850-10-10). It also seems inconsistent with the actual language in PCAOB AU 333 on Management Representations (see footnote 9).

These new requirements assume a level of precision in collection procedures (e.g., capturing *all* related parties and side agreements) that does

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<sup>11</sup> We appreciate that the SEC requirements for disclosing (in proxy statements and other filings) transactions with the company in which any related person had or will have a direct or indirect material interest has a relatively low threshold. However, the respective GAAP and SEC definitions of related parties differ and this represents an area where GAAP and SEC corporate disclosures may not link up.

not exist today in preparers' systems and would require significant incremental effort to achieve. Company control procedures that are in place to meet current related party reporting and disclosure obligations are not at zero thresholds. It is also unclear how companies can address a 100% certainty of no side agreements or other arrangements, no matter how inconsequential. Further, it is unclear what all of the terms mean (e.g., what is covered under "other arrangements"—what its scope should be).

It is almost impossible to make these requirements operational and at the same time retain reasonable levels of procedures. While the auditing standard requires the auditor's work to focus on related party transactions that pose significant risk, the preparer is being required to have procedures to identify related party transactions and side agreements even if they are inconsequential, which appears wholly inconsistent with GAAP (ASC 850). As noted, GAAP requires disclosures of material related party transactions with the objective of providing information that would make a difference in users' decision-making. Bear in mind that related party transactions often occur in the normal course of business, including: sales, purchases, and transfers of real and personal property, services received or furnished, leases of property and equipment, lending and other financial transactions, intra-entity billings based on allocations of common costs, and the list goes on. This level of granularity (not based on GAAP, risk, or materiality) makes it nearly impossible to provide auditors with what they require to meet the interpretation of the new auditing standard. For this quarter, some companies adjusted their management representations for related parties and side agreements or other arrangements to focus disclosure to the auditors of all *material* items. Companies continue to evaluate their current procedures and what they can do to support the auditors need to comply with AS 18, and at the same time retain reasonable control procedures.

v. ***Non-Integrated Inspection Process***

- Companies and management are strong supporters of robust internal controls over business activities and financial reporting. In fact, the main focus of effective business management, top down, starts with risk

assessment followed by establishing effective internal controls over both business practices and financial reporting. Further, internal audit departments plan their activities starting with their assessment of risk and their evaluation of internal controls. External auditors likewise determine their financial statement audit scope and plan by integrating risk assessment and evaluation of internal controls over financial reporting. And, of course, the financial statement audit is integrated with the audit of ICFR for accelerated filers.

However, there seems to be a disconnect between the integrated approach and requirements that business managers, internal auditors, and external auditors use and what some companies understand is the approach used in the PCAOB inspection process. Some companies understand that the inspections of ICFR and financial statement audits are treated by the PCAOB as two separate inspections in that they are staffed with two different and independent inspection teams. It is difficult to understand how two pieces of an integrated audit can be effectively inspected without an integrated understanding of the inter-relationship of risk, controls, materiality, and resulting financial reports. It is therefore not surprising that ICFR inspection findings have increased. The assessment of ICFR alone cannot be done in a vacuum without the complete integrated understanding of a business, its material risks, its internal controls, and its financial statements.

## **C. Materiality**

### ***i. Related to Reclassifications and Disclosures***

- Auditors are required to accumulate information on items that are clearly immaterial at the consolidated level and, in many cases, report this information to audit committees. The PCAOB concluded about three years ago that there was a single threshold for evaluating errors in the balance sheet and income statement. As a result, auditors must accumulate information for balance sheet reclassifications at a threshold as is applied to a net earnings impact and present these to the audit committee in the “Summary of Unadjusted Audit Differences.” This seems wholly

inconsistent with views expressed by the SEC on materiality and leads to non-value added work by auditors, management, and the audit committee. Similar practices do not appear to be followed in other (foreign) jurisdictions.

- In the past year, auditors have begun to extend the “single quantitative threshold” to disclosures. In addition, they have started insisting that if one disclosure item is material than all required disclosures must be presented, regardless of materiality. These disclosure changes have been attributed to the PCAOB inspection staff. These changes have the effect of making the disclosures more detailed without providing material information to investors and are placing additional burdens on audit committees by having to review longer reports and immaterial errors or immaterial information in disclosures. There is a fundamental conflict between these changes and work underway by the SEC and FASB on disclosure effectiveness.
- During the year-end audit process, the auditors identified an adjustment in the tax area for a balance sheet reclassification between line-items. The amount represented a meaningful adjustment when compared against the income statement, but the adjustment was less than 0.5% of total assets and less than 1% of current assets. The reclassification was clearly minimal to any investor that would be reviewing our balance sheet, and it is absurd to conclude that an investment decision would be in any way altered by a minor balance sheet reclassification compared to a large asset base, simply based on how the adjustment measures against operating results. The PCAOB has driven a faulty standard of comparing balance sheet (reclassification) materiality based on an income statement calculation. In addition to discussing this matter extensively with the audit firm, the company also was required to generate significant amounts of documentation on why this matter was not considered to be a material weakness or significant deficiency.

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*ii. Related to Entity-Level Controls*

- Our auditors are now doing more with lower level affiliates that are immaterial individually, but could be material in the aggregate. The view of the PCAOB (the company understands) is that entity-level controls at a higher level cannot be relied upon for these lower material affiliates if the entity level testing is only done for the higher materiality affiliates. So now, the auditors are spending more time and effort testing affiliates that are truly immaterial.

**Conclusion**

Thank you again for your candor and willingness to engage on these issues. Our hope is to start a long-term dialogue to ensure that we have strong controls in place to provide investors with reliable decision useful information to facilitate an efficient capital formation process.

We hope that you find these illustrative examples helpful and we would like to take the next step and work with you to have a meeting of stakeholders to discuss these concerns and identify possible alternatives to address them.

Sincerely,

A handwritten signature in black ink, appearing to read 'T. Quaadman', with a long, sweeping horizontal stroke extending to the right.

Tom Quaadman