

November 25, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034**

Dear Board Members,

Thank you for the opportunity to comment on the significant proposed changes to the accounting and auditing profession through the introduction of two new auditing standards, *The Auditor's Report on an Audit of Financial Statements when the Auditor expresses an Unqualified Opinion* and *The Auditor's Responsibilities regarding Other Information in certain documents containing Audited Financial Statements and the Related Auditor's Report* as well as related amendments to PCAOB Standards.

I am analyzing these proposed changes primarily as a private investor in shares of publicly traded companies but also as a business professional who has had experience dealing with auditors, preparing annual reports and appraising the financial statements of companies in a professional capacity.

**Overview**

I understand that the impetus for these proposed new auditing standards and amendments is the Board's findings that at present the audit report provides little, if any, additional useful information for financial statement users on the conduct of a particular audit. As such, the majority of users only refer to the report to check that it is unqualified. These new auditing standards and amendments are designed to address these apparent shortfalls by increasing the informational value of the audit report and thus promote the usefulness and relevance of the audit conducted and the associated audit report.

However, I have some grave reservations about some of the methods being proposed to achieve the desired outcome and in particular the unintended consequences that may follow. Below I have addressed each of the main aspects of the proposed changes.

**Critical Audit Matters**

The biggest proposed change to the requirements of the auditor's report is the inclusion of critical audit matters ('CAMs'). According to the Board, inclusion of these matters in the audit report is expected to increase the relevancy of the auditor's report and communicate meaningful information to investors regarding the most significant issues encountered during the audit as well as the nature and extent of the auditor's work in forming an opinion on the financial statements of the company.

The Board defines CAMs as the audit matters that, (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence;

and (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. These CAMs are typically of such importance that they are required to be: (1) included in engagement completion documents; (2) reviewed by the engagement quality reviewer; and/or (3) communicated to the audit committee.

By being very prescriptive as to the potential sources of CAMs, the Board has effectively mandated that all auditors must include any issues raised through those three mediums in their CAM disclosure on the audit report. No auditor would want to take the risk of subsequently having to justify failing to include a matter communicated to the audit committee as a CAM. An unintended consequence of this, is that auditors may now think twice before raising a matter in the engagement completion document or to the audit committee, if they do not think the matter is necessarily serious enough to warrant disclosure as a CAM. In my view, such second guessing can only be detrimental to overall audit quality and auditor/management relationships.

A more common malady to the new CAM requirement however, will be the inclusion of too many CAMs not too few, just to be conservative. I am very critical as to how creating multi page audit reports is going to enhance its relevancy or allow it to communicate more meaningful information to the financial statement user. As rightly pointed out, users still primarily focus on the opinion in the audit and burying it in pages of CAMs may obscure it. Another risk, is that users will interpret the CAMs as 'except for' clauses where the audit may have received an unqualified, clean opinion, except for the significant issues raised in the CAMs. This completely undermines the value of providing an unqualified opinion on the financial statements as a whole. At best the reader is confused as to the extent to which the financial statements represent fairly, and at worst, the auditor appears contradictory and thus undependable in their final report.

The reality is, extensive disclosure of critical accounting policies, areas which require management judgment and significant uncertainty are already being made in the pages and pages of notes to the financial statements and are specifically drawn to the attention of the user in the MD&A. Including these issues as CAMs is essentially a duplication in an already lengthy and unwieldy report. If the Board believes there can be more information disclosed to better inform readers, I am not inclined to disagree, however I think that should be enforced through changes to the accounting standards that govern the preparation of financial statements, not by requiring auditors to summarize once again issues already raised elsewhere.

If this proposed new standard on CAMs ever goes live, I think there is serious potential to compromise the independence between auditors and management as management will inevitably try and influence what the auditors include as CAMs. Management would not want an issue to be included as a CAM that is omitted from the MD&A. Thus management and auditors will find themselves working ever more closely on the preparation of the financial statements and associated disclosures. The other danger of course, is that lawyers will be so heavily involved in drafting these CAMs to be watertight legally, that their intended purpose as a specific comment on a particular audit disappears. Companies in the same industries may all end up with the same half a dozen CAMs resulting in the same situation as present, where the user just scans for the opinion on the audit report and ignores the rest.

There is likely to be extensive negotiations on CAMs at a senior level and this is going to be very costly and time consuming for all parties involved. Auditors will be much more focused on mitigating their potential liability should an issue ever arise with an audit client and so will likely devote an inordinate amount of time to drafting CAMs instead of actually focusing on performing quality, core audit procedures. As such, as with

most other proposed changes, the Board should solicit the input of audit firms, financial statement users and senior management to gauge their reactions before proceeding with an overhaul of this nature.

Currently, the auditor has the latitude to issue an unqualified audit report with an emphasis of matter. If an issue was deemed critical enough to warrant an emphasis of matter than by all means it should be included in that section, but to require additional broad disclosures of CAMs seems to add little value to the user who is trying to determine how fairly statements present based on the auditor's report.

At the end of the day, as an investor, I want the auditors to focus on getting sufficient appropriate audit evidence to form their opinion. Additional information that is largely duplicative may be confusing and unnecessary and may detract from the quality of the audit procedures performed. Not to mention the real or perceived risks from increased management and auditor interaction in drafting their relevant disclosures consistently. However I do agree wholeheartedly with the need to make the auditor's report more meaningful, relevant and useful to financial statement users and will share my preliminary thoughts on a more effective way to go about achieving these goals at the end of this letter.

### **Statement on Auditor Independence**

The Board proposes to add a statement to the Audit Report that clearly articulates the auditor's requirement to be independent so as to enhance users understanding of auditors' requirements to be independent and also function as a reminder to the auditors of their obligations.

I agree with the inclusion of statement regarding auditor independence as it more closely aligns US GAAP with a practice that has been occurring under IFRS for several years, to the best of my knowledge. In that way, I support any amendment that standardizes the reporting requirements across regulations and minimizes confusion to financial statement users. In addition, the marginal cost of requiring an additional statement pertaining to auditor independence is essentially nil.

Whether I think a statement regarding auditor independence will actually result in increased independence or additional comfort to users in the opinion expressed is a completely separate matter. This wording is likely to just form part of a standard template that auditors will now utilize and so it is highly unlikely to increase any critical thought on their part regarding their conduct throughout the audit. Without wanting to appear cynical, auditors who are willing to compromise their professional integrity and certification by breaching independence, are unlikely to balk at signing an audit report that contains a statement of independence. Users of financial statements will quickly notice the use of standard 'legal' language regarding independence in all audit reports and so will soon begin to dismiss it as evidence suggests they dismiss the majority of the current audit report except for the opinion.

In Australia for example, auditors are required by the Corporations Act to submit an 'Auditor's Independence Declaration' to the directors of an audit client. It is a one page letter separate and distinct from the Audit Report and is required to be included in the financial statements and annual report of a company (sometimes it is included as part of the Director's Report). This declaration is in addition to the statement of independence already contained in the audit report in accordance with IAASB requirements. I respectfully suggest that the Board work with the SEC to make an independence declaration necessary for auditors as it is a more profound statement (with heavier penalties given it is a requirement of the Corporations Act) that is made to the client's board of directors (who are often mostly non-executive). It is likely to be more effective

as a tool to enhance users' understanding of auditor requirements and also remind auditors of their obligations.

### **Statement on Auditor Tenure**

The Board proposes to add a requirement that the auditor disclose the consecutive years they have served as auditor in the Audit Report. The Board acknowledges that there is mixed evidence as to the impact on audit quality of longer versus shorter tenures, but believes that this information is important to disclose as investors and other report users have indicated a keen interest in it.

At first glance, I was largely indifferent to this proposed inclusion. It seems like a very low cost measure to implement and it does provide additional factual data for users to interpret as they see fit, whether they view long tenure as a threat to independence or short tenure as a risk to auditor competence. So my initial view was that it does not do any harm to include additional information that provides a more complete picture of a company's auditor.

However, after more considered thought, I respectfully submit that the Board is perhaps being halfhearted in its approach in this instance. Why provide information that is completely open to interpretation and consequently diminished in any value it may have to a user? Including information on audit tenure will only cause users to call into question either the auditor's statement of independence or their competence. Neither of these consequences are particularly helpful, when they are completely uninformed. I believe the underlying rationale for inclusion of any data regarding tenure is to allow users to determine the competence and independence of a particular auditor and thus allow the following financial statements to be viewed with additional context. The Board could propose a number of changes that would do a significantly better job of achieving this policy objective than the un-contextualized disclosure of the number of consecutive years of audit tenure. These changes should perhaps include some or all of the following;

#### *1) Reasons as to why an audit firm has been changed*

Any time a public company changes its auditors, it is inevitably noted with interest by the investor and banking community. This usually results in increased scrutiny by stakeholders in the company as they try to ascertain the reasons for the change. There a multitude of reasons for a change in auditor, some practical or innocuous, other reasons are far more concerning, such as disagreements over accounting treatments or financial statement disclosures. At present a company need not provide any reason as to why a change in audit firms occurred except in special situations. In 2006, this meant that reasons were given for only 28.4% of auditor changes. As part of the overarching goal to increase the usability of the auditor report and financial statements generally to users, I think there is some value in requiring disclosure, most likely in the director's report of the reasons for a change in auditor. The reasons provided should be clear enough to be meaningful to users, as such, standard legal verbiage should be avoided.

#### *2) Credentials of first year auditor firm*

Related to the proposal above to provide details of why an audit firm has been changed, it would be useful to provide information to financial statement users as to the credentials of the incoming auditor. This would allow the user to form a subjective view of the level of reliance that can be placed on the opinion expressed in the financial statements. Obviously the auditor must exercise due care, be competent and satisfy the requirement of obtaining sufficient appropriate audit evidence, but the reality is that corporations are undertaking increasingly complex transactions and global operating models and it takes time for a new audit

firm to become intimately familiar with the organization. It is pertinent for users to be aware of the audit firms' past experience with competitors in the same sector, organizations of similar scale and global reach and similar data.

3) *Forced auditor rotation after 5 number of years*

I realize this has been a contentious issue that the Board has proposed in the past and received huge congressional opposition, most recently in July 2013 where a Bill to prevent the PCAOB from forcing public companies to rotate orders was upheld in the House of Representatives by a huge margin. However, I do not think that indicates that the regulation is without merit. Forced auditor rotation could be structured to take place every five years and pertain to lead partners and review managers on a particular client. It does not necessarily have to require a completely new firm to be hired. In that way, it allows firm and partner specific knowledge on a particular client to be shared through appropriate succession planning and thus minimize any loss of audit quality due to lack of experience or familiarity with a particular client. Lead and review auditor rotation does substantially reduce the risk of compromised independence as it would require open collusion between incoming and outgoing partners and managers, a deliberate act that would force most to reconsider the consequences. Forced auditor rotation is consistent with practices in many Commonwealth countries and was ratified by the EU last month, albeit on different terms to what I am proposing. As previously mentioned, anything that aligns PCAOB standards with global best practices should be seriously considered.

**Reporting on 'Other Information'**

Currently the auditor is required to read and consider other information provided in documents that contain the audited financial statements, such as a company's annual report. The auditor is essentially trying to identify material inconsistencies with the audited financial statements and if found, will address them with management.

It appears that the proposed new standard on Other Information is far more onerous. It requires the auditor to read and evaluate other information provided in documents that contain the audited financial statements. The Board believes this will allow the financial statement user to obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description of the results of the auditor's evaluation of the other information.

The Board's expectations in regard to this proposed new standard appear somewhat contradictory. On the one hand, "The Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard" and that "The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit." However, the Board also states that the proposed new standard would, "Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit."

This is unclear to me. It appears that the Board is reticent to create extra work for auditors and is convinced the work is already being performed by many, but at the same time they acknowledge that the significantly higher standard of assurance and responsibility placed on the auditor for other information will likely require

additional procedures to be performed. My view is that auditors are likely to adopt a conservative approach and expend significant time and resources ‘evaluating’ other information outside the financial statements seeing as they are going to be held responsible for it. Given the already limited time frame auditors have to meet all regulatory deadlines, my concern as an investor, is that the quality of their primary financial statement audit procedures will suffer.

There would need to be a significant favorable outcome from a cost/benefit analysis for me to support this proposed new standard as written. Indeed, as the Board suggests, there are likely to be cost implications of this new proposed standard and they should fully evaluate the nature and extent of those costs as submitted by a range of audit firms before deciding to proceed.

I think a more appropriate proposal is for an auditor to merely clarify for the financial statement user the level of work performed on other information outside of the audited financial statements. This shifts the onus back to management to take responsibility for the assertions and claims made in annual reports and other documentation that contains the audited financial statements. Financial statement users should be savvy in knowing that with the auditor clarifying the scope of work performed on the other information they need to analyze all management claims with an appropriate amount of skepticism.

### **Additional standardized language in Auditor’s Report**

I support the proposed improvements regarding the standardized language in audit reports. I believe the phrase “whether due to error or fraud” adds clarity that the intent of management is irrelevant when the auditors consider their responsibility to users of financial statements. However if I were to be cynical, I would suggest that additional standard legal jargon adds little real value to the users of financial statements.

### **Other Matters**

#### *1) The relationship between IAASB and PCAOB*

I have mentioned it on a couple of occasions throughout this letter, but I think it is worth reiterating that wherever possible, it is of significant value to users of financial statements to be able to compare like with like. In an increasingly global world where investing and transacting across borders is becoming easier and cheaper, there is untold value in increasing comparability across jurisdictions. To the extent the Board can be mindful of this as the IAASB concurrently considers changes to its auditor reporting standards, I think financial statement users only stand to benefit.

An example would be the proposed IAASB disclosure requirements of key audit risks (their version of CAMs) along with key audit procedures performed in response to them. The PCAOB proposed standards appear silent on the requirement to state key audit procedures conducted, though the examples provided do contain them. While I may not necessarily agree with the concept of CAMs as proposed, I do think that the final design of the PCAOB standards should harmonize with the final version adopted by the IAASB for its key audit risks.

#### *2) The pass/fail model*

Given the rationale for the substantial changes proposed to audit reports, it was a surprise to see the perfunctory review given to the merits of the pass/fail model of auditing. While it has stood the test of time, I believe that it may be worthy of a more critical review. If we operate from the assumption that the vast

majority of auditors are diligent and competent professionals I believe the PCAOB should be empowering them to exercise their professional judgment in awarding companies a specific rating when they receive an unqualified audit. Just as bonds are capable of having several ratings above junk bond status, not all unqualified audits are created equal.

Rather than taking the disciplinary approach of forcing an auditor to prove that they have done sufficient work through CAMs, and that they are competent and independent through the audit tenure requirement, would it not be preferable to empower auditors by giving them the latitude to exert their professional judgment. CAMs essentially shifts responsibility from the auditor to the end user as the auditor's primary role becomes one of disclosure and the end user is tasked with absorbing and interpreting increasingly voluminous amounts of complex language. However with a rating system, financial statement users will undoubtedly benefit from the increased information conveyed through each rating and perhaps even more importantly, the rating will be easy to identify and interpret.

Obviously a change like this would need to be thoroughly considered and extensively field tested, before it could even be drafted, but I believe that prima facie it may have some merit that warrants further exploration.

### **Conclusion**

Thank you for the opportunity to comment on the proposed new standards in relation to audit reports and the related amendments. I have the utmost faith in the Board's ability to arrive at the most efficacious resolution on these matters for all stakeholders.

Sincerely,

S. Prabhakaran