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September 30, 2011

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

**PCAOB Rulemaking Docket Matter No. 034**  
***Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited  
Financial Statements and Related Amendments to PCAOB Standards***

Dear Mr. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2011-003, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards" (Concept Release).

The Board has requested public comment on its Concept Release that discusses several alternatives for changing the auditor's reporting model in response to concerns from investors and other financial statement users. The objective of these alternatives is to increase the transparency of the auditor's reporting model and its relevance to financial statement users. Such alternatives include (1) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements, (2) required and expanded use of emphasis paragraphs in the auditor's report, (3) auditor assurance on other information presented outside the financial statements, and (4) clarification of certain language in the auditor's report. In addition, the Board requested the consideration of other alternatives not specifically presented within the Concept Release.

**Overview**

We support the Board's objectives reflected in the Concept Release to improve the auditor's reporting model and increase its relevance to financial statement users, and we encourage the Board to undertake a standard-setting initiative to consider improvements to the auditor's reporting model that both serve the interests of investors and provide benefits that outweigh



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 2

their costs. The June 28, 2011 Center for Audit Quality (CAQ) letter to the Board<sup>1</sup>, described several overarching principles for consideration when developing possible areas for further evaluation. These principles, with which we agree, are as follows:

- Auditors should not be an original source of disclosure about the entity; management's responsibility should be preserved in this regard. A fundamental shift from the auditor attesting to information prepared by management to the auditor providing original information about the company could result in unintended consequences that are not in the best interest of investors.
- Any changes to the auditor's reporting model need to enhance, or at least maintain, audit quality.
- Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
- Any changes to the auditor's reporting model should add value and not lead to investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and the independent auditors.
- Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective; however it is important that auditor communications provide objective information about these matters.

In accordance with those principles, we believe the existing relationship between the auditor, audit committee and management is appropriate and should be retained, and that management should continue to be the original source of information about the company's financial position, results of operations and cash flows and related disclosure. Additionally, as further articulated below, we believe that the audit committee is in the best position to provide oversight of the auditor's risk assessment and audit response relative to the most significant matters affecting the financial statements and the audit. While the performance of audit procedures enables an independent auditor to attest to the fair presentation of an entity's financial statements, management who is tasked with supervising the entity's daily operations is in a superior position to provide enhanced disclosures of an entity's business or operations and is responsible for such information. The independent auditor is best positioned to add

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<sup>1</sup> On June 28, 2011 the Center for Audit Quality provided the Board with a partial response to the Concept Release through the submission of ideas that were discussed and shared with the PCAOB staff on June 9, 2011, as part of the Board's outreach efforts. The letter is available at [http://www.theacaq.org/newsroom/pdfs/CAQ\\_June28Letter\\_PCAOBRulemakingDocketMatterNo.34.pdf](http://www.theacaq.org/newsroom/pdfs/CAQ_June28Letter_PCAOBRulemakingDocketMatterNo.34.pdf)



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 3

value to investors by providing assurance about the completeness and reliability of the information provided by management, and such assurance would provide a basis for increased confidence in the information.

### **Suggested Enhancements to the Auditor's Reporting Model**

During the Board's outreach efforts to assess whether changes to the auditor's reporting model may be necessary, investors identified certain information they would recommend including in the auditor's report. Such information included (1) communication of areas with the most significant financial statement and audit risk and the audit work performed in those areas, (2) discussion of significant estimates and judgments made by management, the auditor's assessment of their accuracy and how the auditor arrived at that assessment, and (3) communication of results of sensitivity analyses in significant areas of judgment.

Current SEC rules and regulations require disclosures that substantially overlap with many of the items investors recommended to include in the auditor's report. For example, with respect to material estimates or assumptions with significant levels of subjectivity and judgment (e.g., Critical Accounting Estimates), management is directed to provide within management's discussion and analysis of financial condition and results of operations (MD&A) greater insight into the quality and variability of information regarding financial condition and operating performance and should include, to the extent material, such factors as how management arrived at the estimate, how accurate the estimate or assumption has been in the past, how much the estimate or assumption has changed in the past, and whether the estimate or assumption is reasonably likely to change in the future. Furthermore, the disclosures require analysis of the Critical Accounting Estimate's sensitivity to change, based on other outcomes that are reasonably likely to occur and could have a material impact<sup>2</sup>. Because these significant estimates and assumptions are typically in those areas with the most significant financial statement and audit risk, we believe that these disclosures in MD&A are designed to address the majority of the information requested by investors.

Given that there is such a significant overlap between investor requests for additional information relative to the most significant financial statement and audit risk and the incremental disclosures required within this portion of MD&A compared to what is required by GAAP, we believe that the most effective response to these requests is through a limited expansion of the auditor's role to provide assurance on a Critical Accounting Estimates portion of MD&A, in the form of an attestation examination report on such information.

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<sup>2</sup> Refer to Section 501.14 of Financial Reporting Codification, *Critical Accounting Estimates*, for a description of the required MD&A disclosure requirements for critical accounting estimates.



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 4

Auditor assurance potentially could serve as a means to improve the quality of these disclosures, increase compliance with the SEC staff's stated intent of the disclosures, and provide a basis for increased confidence in the disclosures. Accordingly, we support a limited expansion of the auditor's role to provide examination-level assurance on a Critical Accounting Estimates portion of MD&A. We discuss this preferred alternative further in the section "Auditor Assurance on Other Information Presented Outside of the Financial Statements" below.

We support the clarifications to the standard auditor's report described in the Concept Release and continue to support the retention of the pass/fail auditor's opinion on the financial statements. We believe that users of our reports understand and value the auditor's opinion, a clear and unambiguous statement as to whether the auditor believes the financial statements are presented fairly, in all material respects, in accordance with the identified accounting framework. The retention of the current pass/fail auditor's opinion on the financial statements serves as a focal point from which enhanced auditor communications are driven.

We believe we could implement some form of the alternative that includes the required and expanded use of emphasis paragraphs in the auditor's report. New standards and implementation guidance will be necessary, however, to implement this alternative and to drive consistency among auditors relative to both the population of matters to emphasize and the informational content of these communications. While we would support an approach based on the use of emphasis of matter paragraphs, we believe that an examination-level assurance of a Critical Accounting Estimates portion of MD&A is a more effective response to investor and other users needs, and that the adoption of both the Critical Accounting Estimates attestation and emphasis of matter paragraphs will, in large part, be redundant.

Given that the Auditor's Discussion and Analysis (AD&A) alternative described in the Concept Release would put the auditor in the position of providing original information about the company and its financial reporting that is more appropriately disclosed, or is already required to be disclosed, by management, we do not support this alternative.

The Concept Release suggests that, for both the AD&A and required and expanded use of emphasis paragraphs in the auditor's report, the auditor describe the key audit procedures performed over those areas with the most significant financial statement and audit risk. While we acknowledge the potential benefits of emphasizing in the auditor's report the most significant matters in the financial statements, we do not support the auditor attempting to describe the key audit procedures over these matters. We question whether it will be possible to sufficiently describe the procedures in a concise manner appropriate for the auditor's report that will both give a sufficiently complete description of the many procedures performed in



these most difficult areas and be relevant to financial statement users who may not be familiar with auditing practice. The extent of the necessary discussion is likely to dwarf other components of the auditor's report and accordingly may place undue emphasis on the communicated procedures. Conversely, a brief description of the extensive and sometimes complex procedures performed is likely to raise concerns, or worse, misunderstanding, about the level of the auditor's work and response to risks. Accordingly, we believe that the audit committee is in the best position to assess the appropriateness of, and discuss with the auditor the auditor's response and approach to auditing the most significant and complex portions of the financial statements.

### **Auditor's Discussion and Analysis**

The AD&A alternative presented in the Concept Release is intended to provide auditors with the ability to communicate in a narrative format their views about significant matters. The AD&A may include additional information about the audit, such as audit risks, audit procedures and results, and auditor independence, and a discussion of the auditor's views or impressions regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices and difficult or contentious issues, including "close calls." The Concept Release also indicates that the AD&A could provide the auditor with discretion to comment on material matters for which the auditor believes an issuer's disclosure could be enhanced to improve investor understanding and highlight areas in which the auditor believes management could have applied different accounting or disclosures.

We do not support the AD&A alternative presented in the Concept Release for the following principal reasons: (1) it would put the auditor in the position of providing original information about the company and its financial reporting that is more appropriately disclosed, or is already required to be disclosed, by management; (2) summary information about the audit process is not likely to be meaningful to financial statement users and could be misleading; (3) the potential lack of comparability and consistency between the AD&A of companies with similar risk factors could create further investor confusion; and (4) the information included within an AD&A may become standardized over time, further reducing its effectiveness.

Certain of the information described within the Concept Release for inclusion within the AD&A, such as audit risks, audit procedures and results, auditor independence and the quality of financial statements, is similar to the information that is communicated by the auditor to the audit committee, under existing requirements. Conceptually, we understand that investors may believe that an auditor's required communications with the audit committee could include information they would find relevant and useful. Those written communications, however, are usually a starting point for discussion and are supplemented by significant



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 6

dialogue between the auditor and the audit committee, which typically provides necessary context and perspectives to these communications. This interaction can often clarify specific points raised, particularly relative to certain accounting and financial reporting matters involving a high degree of subjectivity. Additionally, the audit committee obtains insight by virtue of its financial reporting oversight responsibilities, which provide additional context for these communications from the auditor. Absent such two-way dialogue and additional context, this type of information communicated in a general purpose report is likely to be taken out of context or be subject to misinterpretation.

Furthermore, although certain communications currently are required to be prepared under existing auditing standards for purposes of communicating with the audit committee, a requirement to communicate such additional information for general use would impose a responsibility on the auditor with respect to those additional users. To make such communications public would likely result in significant incremental effort and cost to overcome the challenges that may arise in the absence of the dialogue between the auditor and the audit committee. Specifically, communicating such additional information absent the typical accompanying dialogue would require the auditor to substantially enhance these written communications to provide the additional context and explanation necessary to make the communication understandable to persons who do not have access to management, the audit committee and the auditor. Finally, registered public accounting firms would need to consider enhancements to their existing systems of quality control to address additional consultation and review protocols associated with these communications.

We also agree with the sentiment expressed in the Concept Release that disclosing potentially sensitive matters in the auditor's report could impair transparency and openness in discussions between the auditor, audit committee and management. Current auditing standards encourage a free flow of communication between the auditor and the audit committee and the use of executive sessions between the auditor and the audit committee is an effective procedure that allows the audit committee to carry out its statutory oversight responsibilities. Providing the auditor with the responsibility to report directly to the audit committee seeks to ensure the independence and objectivity of the auditor. The Board should consider the potential impact on audit quality and the governance role of the audit committee should comments or presentations made in an audit committee executive session become potential subject matter for inclusion in an auditor's AD&A supplemental report.

The AD&A alternative furthermore includes a discussion by the auditor of difficult or contentious issues, including "close calls." We believe that such matters are likely to be associated with the most complex financial statement accounts and disclosures and those with the highest level of estimation uncertainty. The required disclosures within a Critical



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 7

Accounting Estimates portion of MD&A are designed specifically to address these matters and a part of the auditor's responsibility, as suggested above, could rather be to provide assurance on whether management's required disclosures appropriately describe the factors that contribute to that complexity and uncertainty.

A further shortcoming of this alternative, in our view, is that management and the audit committee may be compelled to change their financial statements, in order to eliminate differences between the company's presentation and disclosures and the auditor's communication in the audit report, thereby defaulting to those judgments and estimates preferred by the auditor. It is not clear that this would result in improved financial reporting given the complexity of business, financial reporting and the nature of "close calls." Furthermore, by virtue of the subjectivity associated with defining a "close call," inconsistency in the nature and extent of these auditor communications would likely result.

Certain investors indicated they could benefit from the information that is provided to audit committees pursuant to PCAOB Rule 3526 that enables the audit committee to monitor the auditor's independence. Similar to other communications with the audit committee, as discussed above, we believe that the information required to be communicated pursuant to Rule 3526 serves as the starting point for the audit committee's consideration of whether the matters communicated have an effect on the auditor's independence. The auditor's written communication is only one part of a process that includes discussion between the auditor and the audit committee. We question the usefulness of this information to financial statement users, especially given the impracticality of communicating directly with the auditor about such matters. Because of this limitation, combined with the complexity of the independence rules, we believe there is a risk that such communications will expand rather than narrow the expectations gap. Furthermore, the suggested clarifications to the standard auditor's report highlight the auditor's responsibility to be independent of the company and that the applicable independence requirements of the PCAOB and SEC have been complied with.

Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. We believe it would be more appropriate for management to provide further disclosure about these risks as they are in a superior position to comment on such matters. We do, however, support the Board evaluating this topic further as a separate project and considering whether the auditor could attest to disclosures of this nature should an appropriate authority develop a framework for such disclosures.



## **Required and Expanded Use of Emphasis of Matter Paragraphs**

This alternative would require inclusion of emphasis of matter paragraphs in all audit reports that would highlight the most significant matters in the financial statements and identify where such matters are disclosed. Based on the discussion in the Concept Release, we believe that the principles underlying the emphasis of matter paragraphs alternative are fundamentally different than the AD&A alternative. Specifically, in an emphasis of matter paragraphs approach, an auditor communicates objective information highlighting significant financial information presented in the financial statements, whereas an AD&A approach focuses on auditor communications of original information relative to significant financial information, or an auditor's impressions relative to that financial information. Accordingly, our comments on the emphasis of matter paragraphs alternative are based on this understanding.

We acknowledge that the auditor's identification of significant matters in emphasis of matter paragraphs and referencing where those matters are disclosed within the financial statements may be helpful to financial statements users. Provided that sufficient criteria exists to provide a basis for auditors to consistently determine which matters should be included in emphasis paragraphs, and the informational content of these communications, we believe that auditors can implement some form of this alternative. We do wish to highlight, however, that those matters identified within the Concept Release for potential discussion within the required emphasis of matter paragraphs are likely to be duplicative of disclosures within a Critical Accounting Estimates portion of MD&A. We believe that an examination of that portion of MD&A by the auditor would be a more effective way of improving disclosure of these important matters, especially given that these disclosures are more appropriately made by management rather than the auditor.

Consistent with feedback received on the French form of auditor's report, which requires similar emphasis of matter paragraphs as those suggested within the Concept Release, we believe these emphasis of matter paragraphs may become excessively standardized over time, which may limit their usefulness to the users of financial statements<sup>3</sup>.

Should the Board pursue this alternative, additional standard-setting activity and resulting implementation guidance will be required to assist the auditor in consistently identifying those matters that should be included in emphasis of matter paragraphs and the nature and extent of the auditor's communication. We believe it will be important for users of the financial

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<sup>3</sup>The French accounting body, Compagnie Nationale des Commissaires aux Comptes (CNCC), engaged an independent consultant to conduct a study on its behalf to examine the perception of the statutory auditor's "justification of assessments" by users of the French form of auditor's report. This study is available at [http://www.cncc.fr/download/footprintconsultant\\_reportstudy\\_va\\_cncc\\_fev2011.pdf](http://www.cncc.fr/download/footprintconsultant_reportstudy_va_cncc_fev2011.pdf)



statements of similar entities (e.g., mid-sized companies in the same industry that operate in similar geographic regions or who have similar products and customers) to expect consistency in the nature and extent of such communications to the extent that risks and other relevant factors affecting the companies are consistent.

We believe that the criteria within the SEC rules and regulations for determining Critical Accounting Estimates for disclosure within MD&A could serve as a basis to establish objective criteria for identifying those significant estimates and judgments that the auditor includes within expanded emphasis of matter paragraphs. With regard to the nature of the communications, we believe that a plain English description by the auditor of why a particular judgment or estimate is significant to the financial statements (e.g., to emphasize the measurement uncertainty disclosed by the issuer) would be more useful to users than a description of the auditing procedures performed over such judgment or estimate. (See also our discussion, above, with regard to the auditor communicating the nature and extent of the auditing procedures applied.) Guidance from the Board to help frame the nature and extent of the auditor's communication also would be necessary.

#### **Auditor Assurance on Other Information Presented Outside the Financial Statements**

This alternative would require an auditor to provide assurance on information presented outside the financial statements such as MD&A, a portion of MD&A or other information (e.g., non-GAAP information or earnings releases).

Under existing auditing standards, the auditor's responsibility for the information presented outside the financial statements is limited to reading the other information included in documents containing audited financial statements and considering whether such information, or the manner of its presentation, is materially inconsistent with information appearing in the financial statements, or includes a material misstatement of fact. Should the auditor identify material inconsistencies or material misstatements of fact within the other information, the auditor is then required to take the necessary steps to address these matters. Auditor assurance on such information, on the other hand, would require the auditor to evaluate whether the information conforms to the requirements for its presentation. Such an evaluation would substantially increase the likelihood that the auditor would identify non-compliance with the requirements and result in improvements to the disclosure. Because the performance of procedures necessary to provide such assurance can be extensive, the Board should take care to require such assurance only on the information that is most important to investors and where auditor assurance can provide increased confidence in such disclosures (i.e., the benefit to investors is greater than the cost).



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 10

As described above, we believe that auditor association with a Critical Accounting Estimates portion of MD&A, in the form of an attestation examination report on such information, would be the most effective manner of addressing the disclosures of information identified by investors as being important to them by providing a basis for increased confidence in such disclosures. That said, based on the investor concerns we have observed, we are not supportive of a requirement for the auditor to attest to the entire MD&A. At this time, we believe that an examination of only a portion of MD&A, a Critical Accounting Estimates section, is the most cost effective approach to addressing investor and other user's needs.

We believe the benefits of an attestation of a Critical Accounting Estimates portion of MD&A will outweigh the incremental costs and will address the information that investors have identified as important. To implement this alternative, the SEC would likely need to amend Regulation S-X to require an auditor examination of the Critical Accounting Estimates. Additionally, a Critical Accounting Estimates section that would be covered by the auditor's attestation report would need to be clearly identified within MD&A and, accordingly, SEC action also may be necessary to effect this change. With respect to existing SEC staff interpretive guidance relative to Critical Accounting Estimates disclosures, we suggest that the Board request the SEC staff to consider the adequacy of this guidance, including whether the interpretive guidance should be formally adopted as a part of Regulation S-K. The PCAOB, in consultation with the SEC, also may wish to consider whether the guidance constitutes suitable criteria for purposes of the auditor's attestation. With respect to the extant PCAOB attestation standards (i.e., AT Section 101, *Attest Engagements*, and AT Section 701, *Management's Discussion and Analysis*), we believe that registered public accounting firms can use these standards to perform and report on an examination-level attestation of Critical Accounting Estimates; however, we would expect the Board to address these issues as a part of any standard-setting project. For both issuer guidance and auditor attestation requirements, we are prepared to assist the SEC and/or PCAOB in addressing the existing guidance and requirements.

The Concept Release further suggests potential auditor association with earnings releases and non-GAAP financial information. Assuming that the demand for the expansion of the auditor's role has market acceptance, we are supportive of further study and consideration (including a cost/benefit test) as a separate project of more precisely defining the auditor's expanded role relative to both earnings releases and non-GAAP financial information. Considerations that will need to be addressed would include:

- Development of an issuer framework for the presentation of earnings releases and auditor performance and reporting standards;



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 11

- Addressing the question of how an auditor would report on earnings release information that is effectively a work in progress (whether an audit or an interim review);
- Addressing, as part of the cost/benefit analysis, whether auditor association with earnings release information would delay the issuance of this information; and
- Consideration of the existing SEC rules and regulations relative to non-GAAP financial information (i.e., both Regulation G and Item 10(e) of Regulation S-K) and auditor performance and reporting standards.

We are prepared to assist the PCAOB and SEC in addressing these considerations and others that may be identified if an expansion of the auditor's role for this information is warranted.

### **Clarification of the Standard Auditor's Report**

We support the suggestions included within the Concept Release to clarify language in the existing standard auditor's report. We furthermore agree that, while this alternative would not significantly expand the content of the auditor's report, the additional explanation of the matters outlined in the Concept Release is likely to provide users with an improved understanding of the audit and the responsibilities of the parties to the financial reporting process. We believe that the suggested clarifications to the standard auditor's report could require similar conforming clarifications within the report on internal control over financial reporting required by Auditing Standard No. 5. Such changes may include further describing reasonable assurance, and management and the audit committee responsibilities for internal control over financial reporting. Similar changes were included within the suggested changes to auditor's reports on the financial statements and internal control over financial reporting as provided by the June 28, 2011 CAQ letter to the Board, with which we are in agreement. Finally, the CAQ June 28 letter includes additional "clarifying language" beyond the areas identified in the Concept Release. We also are supportive of these additional auditor communications.

### **Other considerations**

In addition to the alternatives described within the Concept Release, we would encourage the Board to further consider the following:

*Scope of enhancements to the auditor's reporting model.* The discussion in the Concept Release is principally focused on improving communications with investors. The Board should consider whether these changes will benefit other financial statement users before requiring such reporting for all types of entities whose audits must be conducted pursuant to



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 12

the standards of the PCAOB. For example, it is not clear that all such communications would be important to the users of the financial statements of a broker-dealer who are not invested in the company.

*Field tests.* The Board should consider field testing the more significant of the proposed alternatives to evaluate the value and practicability of the alternatives. In particular, we believe a field test would be especially helpful in determining the feasibility of implementing the AD&A or required emphasis of matter paragraphs alternatives.

*Global coordination.* The issue of an auditor's reporting framework, and the broader financial reporting framework, are the subject of consultations in other jurisdictions. For example, the International Auditing and Assurance Standards Board (IAASB) has issued a Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*<sup>4</sup>; the U.K. Financial Reporting Council has undertaken a project on effective company stewardship; and the European Commission has issued its Green Paper that addresses the auditing profession, including the reporting framework. In addition to working with the regulators in the U.S., such as the SEC, we encourage the Board to participate in and consider these other consultations in assessing the appropriate changes under PCAOB professional standards.

*Other potential alternatives.* The IAASB Consultation Paper described above suggests as a possible option to enhance the quality, relevance and value of auditor reporting, an enhanced model of corporate governance reporting, which may include the audit committee issuing a report describing its oversight of the financial reporting process and the audit, accompanied by auditor assurance. We believe this potential alternative is worthy of further consideration as another means of providing additional information called for by certain investors.

*Impact of increased professional liability for auditors and issuers.* We believe it is incumbent on the Board to consider the potential that one or other of the proposed changes may open up new fronts of liability exposure to claims by users of the financial statements. The cost of responding to civil damage suits already represents a significant operating cost for registered public accounting firms. Incremental forms of assurance required to be provided by the auditor, especially those with a higher level of inherent subjectivity or which call on the auditor to provide information about the company that is independent of the company's own disclosures (such as an AD&A), are likely to result in exposure to novel litigation claims that may substantially increase such costs. We urge that the Board give close consideration to

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<sup>4</sup>In May 2011, the IAASB issued their consultation paper to explore possible options to improve the communicative value of the auditor's report. The consultation paper is available at <http://www.ifac.org/publications-resources/enhancing-value-auditor-reporting-exploring-options-change>.



Office of the Secretary  
Public Company Accounting Oversight Board  
September 30, 2011  
Page 13

balancing the perceived benefits to users of the financial statements with the resulting increased professional liability as the Board moves forward with its proposals.

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We appreciate the Board's careful consideration of our comments, and fully support the Board's efforts to enhance the auditor's reporting model and increase the value of the audit. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, [sranzilla@kpmg.com](mailto:sranzilla@kpmg.com), or Tom Ray, (212) 909-5095, [tray@kpmg.com](mailto:tray@kpmg.com).

Very truly yours,

**KPMG LLP**

Cc:

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