



MUTUAL FUND DIRECTORS FORUM

The FORUM for FUND INDEPENDENT DIRECTORS

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006

PCAOB Rulemaking Docket Matter No. 034

Dear PCAOB Board Members:

The Mutual Fund Directors Forum (“the Forum”)¹ welcomes the opportunity to comment on the proposed auditing standards dealing with the auditor’s report, PCAOB Release No. 2013-005 dated August 13, 2013 (“Proposal”).

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern. As fiduciaries charged with protecting the interests of mutual fund shareholders, we are deeply interested in fund disclosure. Further, fund directors value and wish to preserve the benefits of the relationship with their independent auditors.

I. Introduction

We appreciate the PCAOB’s goal to “increase the informational value of the auditor’s report to promote the usefulness and relevance of the audit and the related auditor’s report.” We are concerned, however, that key provisions of Proposal will not achieve these goals with respect to investment companies that file under the Investment Company Act of 1940 and the Securities Act of 1933 (“Registered Investment Companies”).

Specifically, we have two primary concerns with the Proposal. The first is that disclosure of “critical audit matters,” as proposed, has the potential to disrupt the relationship between a Registered Investment Company’s independent auditors and the board’s audit committee, making the audit committee less effective. Audit committee members should have the freedom to discuss a wide variety of topics, issues and concerns, without consideration of how and whether such matters might be discussed in an audit report. Second, the additional disclosure that would be required under the Proposal would not be beneficial to shareholders and is unnecessary in light of currently required financial statement disclosure for Registered Investment Companies. We therefore do not believe the proposal should be applied to Registered Investment Companies.

¹ The Forum’s current membership includes over 775 independent directors, representing 105 independent director groups. Each member group selects a representative to serve on the Forum’s Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum’s Board of Directors, although it does not necessarily represent the views of all members in every respect.

II. Requiring Disclosure of Critical Audit Matters Will Result in Reduced Communication Between Audit Committee Members and Auditors

Audit committees play a central role in the protection of investors. Specifically, audit committee meetings, and particularly executive sessions, provide directors and their auditors opportunities to explore openly a wide variety of issues, no matter how large and no matter how seemingly immaterial. A free give-and-take between the audit committee members and the auditors regarding the fund's risk control environment, accounting processes, the quality and sufficiency of resources devoted to accounting and compliance functions and other matters is critical. Frank discussion of these and other issues can help directors gain a deeper understanding of the funds they oversee and the management companies that serve those funds.

These discussions are effective in part because the participants, and particularly the independent directors, do not need to worry whether the topics will be disclosed in any public fashion, and hence whether they will later be analyzed and second-guessed by regulators, plaintiffs' attorneys or others. Once a disclosure regime is imposed on top of these communications, the focus will inevitably shift to managing discussions in a way that insulates the parties by minimizing the necessary disclosure. The proposed requirement that critical audit matters be disclosed will thus likely chill this highly beneficial, free-flowing communication between auditors and directors.

Reducing the quantity and quality of communications in audit committee meetings as a by-product of regulatory reform will harm fund investors. Indeed, such a result runs counter to the express goal of PCAOB audit standards such as Auditing Standard No. 16, Communications with Audit Committees, which expressly sought to encourage effective two-way communication between the auditor and the audit committee. As regulators have long recognized, a healthy working relationship between a fund's audit committee and its independent auditors is critical to foster a good financial reporting environment.²

III. Disclosure of Critical Audit Matters in Audit Reports Should Not Apply to Registered Investment Companies

We do not believe the disclosure of critical audit matters should be applied to Registered Investment Companies. Unlike operating company investors, Registered Investment Company shareholders are primarily retail investors who need clear and concise information. We believe the proposed disclosure of "critical audit matters" in this context is both unnecessary and potentially misleading to fund shareholders.

A. Registered Investment Companies Are Transparent And Their Material Accounting Policies Are Fully Disclosed

With respect to auditing and accounting issues, Registered Investment Companies are transparent and inherently less complex than operating companies. Substantially all of an investment company's assets are investments, with income from returns on those investments. The financial statements contain a detailed schedule of investments. Expenses are in the form of contractual arrangements with third parties, which are approved and overseen by fund independent directors.

The Proposal seeks disclosure of critical audit matters in the audit opinion because "company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor

² As the SEC has noted, "By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practice." Release 33-8220, Standards Relating to Listed Company Audit Committees, effective date April 25, 2003.

as part of the audit, but this information is not usually known to investors.”³ While operating companies may have complex operations, off-balance sheet items and other accounting issues less visible to investors, such issues do not arise in the Registered Investment Company context. Registered Investment Company financial statement disclosures are comprehensive and already adequately identify areas of risk and complexity, including valuation of investments, as well as identification of all significant contractual relationships and related party transactions. As a result, fund shareholders now have information about the most challenging areas of the audit, and there is no clear benefit from additional discussion in the audit opinion.

For many Registered Investment Companies, the only potential “critical audit matter” is auditing the valuation of hard to value investments that do not have readily available market prices. While fair valuation matters may require a significant time commitment from the audit team regardless of materiality, prospectuses and financial statements currently include extensive disclosure about valuation policies and procedures, including a description of the inputs used in fair valuations. Thus, while the auditor’s evaluation of fair values may, in fact, “involve the most difficult, subjective or complex auditor judgments” in the audit of a Registered Investment Company, we do not believe there is benefit to investors to re-stating what is currently fully disclosed elsewhere. Disclosure of fair valuation as a “critical audit matter” under these circumstances will wrongly imply that the already fulsome disclosure in the financial statements is incomplete or inadequate in some manner.

B. Uneven Disclosure Will Mislead Fund Shareholders

Many investment company complexes offer funds with strategies and investment portfolios that are similar to funds offered by other complexes. Indeed, fund investors often look to a “peer group” of funds in order to evaluate their own fund selection. However, should audit firms interpret and apply disclosure of “critical audit matters” differently, shareholders risk being affirmatively misled.

For example, in a peer group of funds with similar investments and strategies, one audit firm may identify fair valuation as a “critical audit matter” because it involved “the most difficult, subjective or complex auditor judgments.” Two other audit firms may not identify any critical audit matters for funds in the same peer group because, although time consuming during the audit, the firms conclude that the issues did not rise to a level requiring additional discussion in the audit opinion.

As a result, shareholders will be presented with significantly different audit reports for a peer group of funds with similar investments and strategies, not because of real differences in the funds but because of the differing audit firm interpretations of the rule. Investors may attribute the substantial differences in the auditors’ evaluations of how one of the funds in the peer group fair values its securities, to the amount of risk inherent in a particular fund’s portfolio. This erroneous conclusion could lead to poor investment decisions, as investors shun funds within a peer grouping that appear to have issues connected with fair valuation of securities.

One potential solution to inconsistent application of the PCAOB standard to different fund audits could be to standardize disclosure so there are virtually no differences between audit reports on funds with similar investments and strategies. The resulting boilerplate, while adding additional disclosure, will not add useful information of value to investors.

C. Disclosure of Critical Audit Matters Will Reduce the Utility of Audit Reports for Fund Shareholders

Investment company complexes do not file a single set of quarter or year-end statements, as do other reporting entities. Different funds within a single complex may have different year-ends. Funds within the same investment company complex generally will share accounting and valuation functions and therefore will be included in a combined annual report. Accordingly, one audit opinion will generally cover numerous funds in a

³ PCAOB Release No. 2013-005 (August 13, 2013) (“Release”) at p. 6.

complex that share the same year-end. Disclosure of critical audit matters, however, would likely only involve some subset of the funds opined on, and thus would have to occur on a fund-by-fund basis. Shareholders, rather than having a crisp statement of audit conclusions for all funds in the complex sharing the same year-end, would have to wade through pages of audit reports seeking one that is applicable to their fund. This additional layer of complexity in fund disclosure does not seem to be in shareholders' best interest.

D. Disclosure of Audit Procedures Performed on Critical Audit Matters For Investment Companies Is Not Useful

The PCAOB asks if including the audit procedures performed, including resolution of the critical audit matter, in the audit report would be helpful to investors. We believe such disclosure would not be helpful in the Registered Investment Company context.

As noted above, Registered Investment Companies currently are required to disclose policies and procedures for significant accounting issues such as fair valuation of securities. Audit procedures for obtaining independent verification of individual fair values are simply not susceptible to a short explanation in the auditor's report. In order to provide context for the decisions made, the auditor would need to include a level of detail that would overwhelm the audit report.

Given the fact that the policies and procedures followed by the fund are fully disclosed in the financial statements, adding pages of additional information to the audit report about how values are tested will not add to shareholders' understanding of the accounting issues presented. Rather, such detail will likely make it less clear to fund investors whether the auditors are satisfied with the policies and procedures followed by the fund.

IV. Other Issues

A. The PCAOB Should Be Clear that Some Audit Entities Will Routinely Have No Critical Audit Matters

Should the Proposal be adopted and require Registered Investment Companies to comply with the new disclosure, the PCAOB should make clear that an audit may not generate any critical audit matters. This will occur when the issues that require the most audit effort (such as fair valuation of securities in the case of a Registered Investment Company) are fully disclosed in the financial statements. We see no additional value to fund shareholders of providing additional information as to how fully disclosed matters have been addressed in the audit. To the contrary, such a discussion may result in shareholder confusion as to whether the auditors are satisfied with the information disclosed in the financial statement footnotes.

B. The PCAOB Should Engage in Investor Testing Before Requiring Additional Information in the Audit Report

The Proposal includes two new auditing standards that would each increase substantially the volume of information conveyed to investors through the auditor's report. Registered Investment Companies, unlike operating companies, have a primarily retail shareholder base. As the SEC has realized, disclosure intended to inform retail shareholders should not be overwhelming. In 2009, for example, the SEC adopted a "summary prospectus" rule requiring all open-end funds to use a summary prospectus format in the first few pages of a fund prospectus. The rule requires presentation of a short list of critical items relevant to shareholders, including investment objectives, costs, principle investment strategies, risks and performance, and so on. The SEC's summary prospectus rule is a result of investor testing showing that short, crisp, clear disclosure improves fund shareholder comprehension.

Both of the proposed audit standards, the “critical audit matters” and the “other information,” will result in more information in the auditor’s report. The PCAOB should conduct investor testing, as the SEC did in adopting the short form prospectus, prior to adoption of these audit standards to assess whether in fact the additional information is useful to fund shareholders and whether any incremental benefits will outweigh the additional audit fees shareholders will bear.

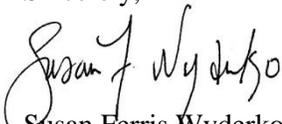
C. Disclosure of Auditor Tenure

The Proposal also seeks comment as to whether information regarding the tenure of the audit firm would be so useful to investors and other financial statement users that it should be highlighted in the auditor’s opinion. With respect to Registered Investment Companies, we believe the answer is “no” because the inclusion of this single fact in the audit opinion would wrongly imply that it is a factor of singular importance.

Auditor tenure is, in the context of Registered Investment Companies, simply not such an overwhelmingly critical factor in the selection of auditors by a fund’s audit committee to deserve special focus in the auditor’s report. To the extent that disclosing in the audit report the tenure of the audit firm will imply that auditor tenure outweighs any other considerations in the selection of auditors, we believe this requirement is not in the best interest of fund shareholders.

We look forward to continuing to participate in this ongoing discussion, as independent directors have an important role to play in fostering healthy communications with fund shareholders. If you would like to discuss our comments further, please feel free to contact us at 202-507-4488.

Sincerely,



Susan Ferris Wyderko
President, CEO

cc: James R. Doty, PCAOB Chairman
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