August 18, 2017

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: SEC Release (No. 34-81187; File No. PCAOB-2017-01) on *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*

Dear Mr. Fields:

The Society for Corporate Governance (the "Society") appreciates the opportunity to provide comments in response to the U.S. Securities and Exchange Commission ("SEC") notice to solicit comments on the Proposed Rules, *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* (the "Proposed Rules"), SEC Release (No. 34-81187; File No. PCAOB-2017-01).

Founded in 1946, the Society is a professional membership association of more than 3,400 corporate and assistant secretaries, in-house counsel, outside counsel and other governance professionals who serve approximately 1,600 entities, including 1,200 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and the executive managements of their companies on corporate governance and disclosure matters.

General Comment

The Society applauds the efforts of the Public Company Accounting Oversight Board (the "PCAOB") and SEC to improve the quality of public company auditor reports for investors. The Society also appreciates that the Proposed Rules address several of the concerns raised in a prior comment letter submitted by the Society[1] to the PCAOB on the Proposed Auditing Standards issued on August 13, 2013 (the "2013 Proposed Rules"), including narrowing the scope of the definition of critical audit matters, incorporating a materiality element to such definition, and eliminating consideration of a standard regarding the auditor's responsibilities for other information outside the financial statements. However, the Society continues to believe that requiring auditors to communicate critical audit matters in their reports (i) may cause auditors to supplant the judgment of companies concerning their public disclosures and (ii) will impose

[1] Prior comment letter can be found here: https://pcaobus.org/Rulemaking/Docket034/233b_SCSGP).pdf

significant costs without providing a meaningful contribution to the information already available to investors.

SEC Chair Jay Clayton has noted that "regulatory actions drive change, and change can have lasting effects," and that the cumulative burden of some of these regulatory actions may have a lasting detrimental effect on the market.[2] The Society strongly agrees with this sentiment and that costly and burdensome disclosure requirements, such as the Proposed Rules, have made becoming and remaining a public company increasingly difficult. We also appreciate the Chair acknowledging the importance of rigorously analyzing each proposed new regulation to ensure that the potential benefits outweigh the costs.[3] With respect to the Proposed Rules, the Society does not believe that the PCAOB's economic analysis is sufficient to demonstrate that investors will benefit from auditor communication of critical audit matters to an extent that outweighs the significant one-time and ongoing costs that will be borne by companies, auditors, and ultimately shareholders. The concerns regarding critical audit matters are discussed in greater detail below.

Mandatory communication of critical audit matters will alter the fundamental relationship between auditor and audit client; may require the auditor to disclose sensitive information that its client may have determined is not legally required to be disclosed, resulting in harm to the client; and may reduce disclosure effectiveness.

As set forth in the Proposed Rules, the auditor must (i) identify the critical audit matter; (ii) describe the principal considerations that led the auditor to determine that the matter is a critical audit matter; (iii) describe how the critical audit matter was addressed; and (iv) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. The Society believes that requiring auditors to communicate critical audit matters will cause them to make substantive disclosures concerning companies that will effectively substitute auditors' judgment for that of companies and thus alter the role of auditors and companies in ways that will not benefit investors, companies or auditors.

An essential feature of the public company reporting system is that the company is responsible for disclosure about the company, just as it is responsible for preparing its own financial statements. The company's disclosures are made by management under the oversight of the company's board of directors and the audit committee of the board of directors. The role of the auditor is to attest to certain information provided by management and to report separately to the audit committee. These distinct roles and responsibilities have been a critical part of the audit process and report since the 1940s.[4]

The PCAOB made an effort to address concerns that the Proposed Rules blur the separation between company and auditor. In the Proposed Rules, the PCAOB emphasizes that auditors will be required to disclose original information about a company only with respect to

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[2] See Chairman Jay Clayton, Remarks at the Economic Club of New York (July 12, 2017), available at https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[3] Id.

[4] AU Section 508.08 (describing as one of the basic elements of the audit report, "[a] statement that the financial statements are the responsibility of the Company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit").

"areas uniquely within the perspective of the auditor: describing the principal considerations that led the auditor to determine that the matter is a critical audit matter and how the matter was addressed in the audit." While the Society appreciates the PCAOB's effort, the Society believes that the Proposed Rules nevertheless will have negative unintended consequences.

For instance, the auditor's discussion of critical audit matters likely would result in the disclosure of sensitive information that a company may otherwise determine is not required to be disclosed and such disclosure could damage the company. Auditors may be required to describe in their reports, for example, a company's internal processes and controls, if relevant to the auditor's identification of a critical audit matter and/or how the matter was addressed. Those descriptions could identify potential significant deficiencies required to be communicated to auditors under PCAOB rules but not required to be publicly disclosed by the company. Although the PCAOB stresses that auditors are not required to use the specific term "significant deficiency,"[5] companies may feel compelled to expand their disclosures to add context to internal control deficiency descriptions included in auditor reports, in effect publicly describing and/or addressing significant deficiencies despite not otherwise being required to do so. The PCAOB believes such expanded company disclosures could be an indirect benefit of the Proposed Rules, yet the SEC and its Staff previously determined that the focus of internal control reporting should be on the most important control issues — those items that could result in material errors in the financial statements (*i.e.*, material weaknesses) — rather than on lesser control deficiencies.[6] In our view, additional disclosures about control deficiencies brought about in the context of matters described as "critical" but that could not result in material financial statement errors would confuse investors and likely obscure, and thereby render less effective, the more meaningful disclosures already required by SEC rules and regulations.

In addition to exacerbating disclosure ineffectiveness, which is among those issues identified by the SEC as problematic and slated for potential reform,[7] the Proposed Rules could result in two sets of disclosures of the same facts — one made by the company and the other made by the auditor. This poses the substantial risk of inconsistent narratives concerning the

[5] The PCAOB offers the following example: "if a significant deficiency was among the principal considerations in determining that revenue recognition was a critical audit matter, the auditor would describe the relevant control-related issues over revenue recognition in the broader context of the critical audit matter without using the term 'significant deficiency.'"

[6] See SEC Release No. 34-55929, Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, available at https://www.sec.gov/rules/interp/2007/33-8810.pdf, at footnote 52 ("Significant deficiencies in ICFR are not required to be disclosed in management's annual report on its evaluation of ICFR required by Item 308(a)"); and SEC Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005), available at https://www.sec.gov/info/accountants/stafficreporting.pdf, at footnote 7 ("The staff . . . believes that the Commission's rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrates attention on the most important internal control issues").

[7] See Chairman Jay Clayton, Remarks at the Economic Club of New York (July 12, 2017), available at https://www.sec.gov/news/speech/remarks-economic-club-new-york; Chair Mary Jo White, Address at the National Association of Corporate Directors - Leadership Conference 2013 (Oct. 15, 2013), available at www.sec.gov/News/Speech/Detail/Speech/1370539878806#.Uq3hN4bTmM8; Commissioner Daniel M. Gallagher, Remarks at the 2nd Annual Institute for Corporate Counsel (December 6, 2013), available at www.sec.gov/News/Speech/Detail/Speech/1370540462287#.UqXJTYbTmM8.

company on matters described as "critical." The fact that there may be two sets of disclosures about such matters, driven by differing standards and interests, could create further investor confusion, increased litigation risk for companies and unnecessary disagreement between the auditor and the company.

The disclosure of critical audit matters also seriously threatens to chill communications between the auditor, on the one hand, and members of management and the audit committee, on the other. Because the Proposed Rules apply to all matters communicated to the auditors (versus only required communications), for example, we are concerned that management and audit committees will be reluctant to voluntarily discuss potentially important matters with their auditors until the implications for disclosure have been fully considered. A company's management or audit committee must be able to raise and resolve matters with the auditor in a timely manner without fear that their communications will be publicly disclosed in situations where those matters are satisfactorily resolved.

The compilation and disclosure of critical audit matters would require significant time and attention from the auditor, the company's audit committee and management.

The Society is concerned that auditor disclosure of critical audit matters will increase the time burden for the auditor, the company's audit committee, and management during an otherwise already time-constrained period as management finalizes its annual financial statements for inclusion in their annual reports and transaction related SEC filings. Many public companies, for example, must file their Forms 10-K within 60 days after the end of the fiscal year. During this compressed period, management must, among other things, compile the financial statements, including financial statement footnote disclosure, prepare the management's discussion and analysis, and complete its assessment of internal control over financial reporting. Management must coordinate this process with its auditor while allowing sufficient time to review the proposed disclosures with, and be responsive to input from, the audit committee. During the same time, the auditor must, among other things, complete its audit of the financial statements and the attestation of the internal control over financial reporting, review its work with the audit committee and management, and finalize its reports.

Adding to this heavy workload, the Proposed Rules would require the auditor to draft and review internally and with the audit committee very sensitive disclosure. Realistically, this is likely to entail negotiations among the audit committee, management, and the auditor over the proposed substantive content disclosures, not unlike the interactions that often take place today with regard to footnote disclosure, management's discussion and analysis, and risk factors. These additional burdens may diminish the time available to ensure the accuracy and completeness of these disclosures to devote more time to critical audit matters, in some cases not only adversely impacting the financial statements and management's discussion and analysis but also potentially delaying the relevant SEC filing.

For example, under today's regulatory regime, assume that management completes its complex fair value analysis in connection with its goodwill and determines that its fair value exceeded its carrying value. It reviews that determination with its auditor, which concurs, and with its audit committee. Management also drafts appropriate management's discussion and analysis disclosure relating to its critical accounting estimates. As the current rules require, it reviews this disclosure with both its auditor and audit committee. The Proposed Rules then would additionally require the auditor to assess whether this was a critical auditing matter and, if so, prepare the required disclosure. Due to the nature and content of the auditor's critical auditing matter disclosure as contemplated by the Proposed Rules, this last step will almost certainly encompass the audit team's review and behind-the-scenes dialogue and negotiation with the auditor's local and potentially national office, presentation of draft disclosures to management and the audit committee, meetings between management and the audit committee to review and discuss, further meetings between the auditor, management and the audit committee to review the company's proposed wording changes to the auditor's proposed disclosure and re-review of the document for potential internal inconsistencies based on the inclusion of the auditor's disclosure, which ultimately is likely to add at least several days to the process.

The Society appreciates the PCAOB's attempt to address concerns raised in connection with its 2013 Proposed Rules by adding requirements that a critical audit matter must (i) relate to accounts or disclosures that are material to the financial statements and (ii) have involved especially challenging, subjective, or complex auditor judgment. The Society, however, believes that these added concepts ultimately will not narrow the number of critical audit matters disclosed. In fact, it could exacerbate the problem by adding further discussions among the auditor, audit committee, and management as to whether the proposed critical audit matter meets all elements of the definition included in the Proposed Rules. We would also expect that auditors will be motivated to take the position that the vast majority of communications made or required to be made to the audit committee are both material to the financial statements and involve especially challenging, subjective, or complex auditor judgment. Under the Proposed Rules, the Society expects auditors to err on the side of disclosure as there is no downside for the auditor to over-disclose critical audit matters. The harm in over-disclosure will fall on the company and investors who may be confused by such critical audit matter disclosure.

The cost of reporting critical audit matters would greatly outweigh any actual or perceived benefits.

As in its comments on the PCAOB's 2013 Proposed Rules, the Society continues to be concerned that the costs associated with the additional steps described above will greatly outweigh any benefits to investors. Communication of critical audit matters will increase time spent by the auditor on field work, documentation and discussions with management; increase the time and focus of the auditor's national office; and increase the auditor's potential liability on each audit engagement. As we learned from the implementation of the attestation requirement over management's assessment of internal controls, when an auditor must spend more time on an audit and faces increased liability, those costs are passed on to the company to absorb (ultimately reducing shareholder returns). The additional management time and attention devoted to coordinating with the auditor on disclosures of critical audit matters will also increase costs for the company and ultimately the company's shareholders.

The cost of an audit will increase to the extent that the auditor communicates more critical audit matters. Magnifying this concern is that auditors will almost certainly be inclined to over-report critical audit matters rather than under-report them for at least two reasons. First, auditors may be fearful of being second-guessed during the PCAOB's review of the audit firm's work.[8] It will be in the auditor's best interest (rather than the best interests of the company or users of the financial statements) to err on the side of over-inclusion. Second, in the event a company declares bankruptcy or finds a material misstatement in its financial statements, if the auditor had not listed the potential financial issue as a critical audit matter, it would potentially face increased malpractice liability regardless of whether the audit was adequately planned and carried out. Thus, the Society foresees each auditor identifying excess critical audit matters just to provide some "cover" in the event a potential risk materializes. To the extent that an otherwise lower risk audit matter is deemed to be potentially "critical" by the auditor, additional field work may have to be performed to demonstrate that sufficient audit evidence was gathered or that the matter was not a critical accounting matter. Both of these likely outcomes will directly increase audit fees.

The Society strongly believes that adding complexity to the auditor report will not simplify the financial statements or otherwise benefit their users. The disclosure of critical audit matters would frustrate the PCAOB's stated intention that "the Board's proposed auditor reporting standard would retain the pass/fail model." In effect, the disclosure will transform the current binary pass/fail model into a qualitative report. Depending upon the nature and extent of critical audit matters and the auditor's comments on those matters, the report will constitute and will be perceived as the equivalent of "high pass," "medium pass," "low pass," and "fail" or similar "grades" — which would add complexity and uncertainty for investors that does not exist with the current pass/fail system. Further, if two companies had similar issues that involved auditors' complex judgments or posed difficulty for the auditors to obtain evidence or form an opinion, but one company's auditor elected to over-report critical audit matters, then it would appear that the company with more reported critical audit matters was a riskier investment despite the companies posing substantially similar risks. At a minimum, this would confuse investors.

Finally, we believe that the Proposed Rules will result in a substantial increase in litigation risk for both the auditor and for the company. As noted above, the role of the auditor is not to be a guarantor of the financial statements. However, the Proposed Rules will change the perception of the auditor's responsibility, and the auditor's litigation risk is likely to increase accordingly.[9] To the extent that an auditor's legal risk increases, the cost of that risk will be passed on to the issuer in the form of higher rates. In addition, the inclusion of critical audit matters in the audit report will create a "road map" for plaintiffs to sue the company when, in hindsight, a critical judgment turns out to have been faulty. Arming potential plaintiffs with this information will increase the litigation risk for the auditor and the company as well as its management, which will increase costs to the company.

[8] See Appendix 1 to the Release ("Note: it is expected that in most audits, the auditor would determine that at least one matter involved especially challenging, subjective or complex auditor judgment").
[9] See Appendix 1 to the Release ("Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used").

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The Society respectfully submits that, in weighing the costs and benefits of the Proposed Rules, the PCAOB did not adequately assess the above-outlined direct and indirect costs of the Proposed Rules to issuers or the indirect impact of such costs on capital markets, investors and the overall economy. For these and all the reasons described herein, the Society encourages the SEC to request the PCAOB to revise the Proposed Rules to address the concerns regarding critical audit matters, including by conducting an updated cost/benefit analysis. We appreciate this opportunity to share our views with you and would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

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The Society for Corporate Governance