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August 18, 2017

Via E-mail: rule-comments@sec.gov

Securities and Exchange Commission,
100 F Street, N.E.,
Washington, D.C. 20549-1090.

Attention: Mr. Brent J. Fields, Secretary

Re: Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures from Unqualified Opinions and Other Reporting Circumstances, and the Related Amendments to Auditing Standards:
File No. PCAOB-2017-01

Ladies and Gentlemen:

This letter is in response to the Securities and Exchange Commission's request for comments, in Release No. 34-81187 (July 21, 2017) (the "Release"), on the proposed auditing standard relating to the auditor's report on an audit of financial statements, which was recently adopted by the Public Company Accounting Oversight Board (the "Board"). We appreciate the opportunity to submit these comments for the Commission's consideration.

We believe that the proposed standard's new requirement to include a discussion of "critical audit matters" in the auditor's report – which must include a description of "the principal considerations that led the auditor to determine that the

matter is a critical audit matter”¹ – is likely to have unintended consequences that increase costs and are detrimental to the quality of issuers’ disclosure and governance processes. The Board has been working on this auditor’s report project for many years, and we would acknowledge that over that period it has thoughtfully refined the proposal in light of many comments received. If the Board had been implementing some legislative or other mandate to add “critical audit matters” disclosure to the auditor’s report, we would have no substantial comments on the rules it adopted. But there is no such mandate, and so, we would submit, it falls to the Commission to determine whether the newly required “critical audit matters” disclosure would on balance produce an improvement to the quality of information investors receive, without undue adverse consequences.² We believe strongly that it will not, and that the Commission should therefore decline to approve the proposed standard.

As in previous comment letters we submitted to the Board on its auditor’s report proposals, our comments here are based on our perspective as lawyers regularly engaged in advising issuers on disclosure and reporting matters, and are informed by two key considerations:

- the issuer should be the original source of any disclosure about the issuer or its results of operations or financial position, and

¹ See proposed AS 3010.14.b.

² We believe this follows from the relevant approval criterion under §107(b) of the Sarbanes-Oxley Act: that the Commission find that the rules as adopted by the Board are “necessary or appropriate in the public interest or for the protection of investors.”

- the best way to capture, for the issuer and its shareholders, the benefits of the auditor's insights and experience is for the auditor to have full and open interaction with the audit committee.

The requirement to include discussion of "critical audit matters" in the auditor's report, as approved by the Board, continues to implicate these considerations. While much of that new auditor's report discussion will focus on the audit itself (*see* AS 3101.14.c), we expect that the disclosure as to *why* a matter was designated a "critical audit matter" will frequently include disclosure of issuer information not otherwise required to be disclosed. We note that the proposed rule explicitly acknowledges this possibility (*see* AS 3101.14, Note 2).

One obvious example of such disclosure, we expect, would involve "significant deficiencies" in the issuer's internal control over financial reporting. In identifying "critical audit matters" under the proposed rule, the auditor is directed, in several places, to consider the nature and extent of audit effort required. We expect that the state of the issuer's internal control over financial reporting, as applied to the particular matter or more generally, would commonly be an important factor in that consideration. We do not understand the Board's assertion (reflected in the Release, in the text at note 26) that this disclosure will not make reference to "significant deficiencies". With respect, while it may literally be possible to describe many situations without using that term, we expect that it would often be clearest and most direct to include that term in the explanation. Presumably, the auditor would be expected to give a frank and direct explanation of its determinations of "critical audit matters", not an indirect and technical one. It seems to us inherent in the nature of the required disclosure that, where applicable, such explanations would commonly refer to "significant deficiencies", which generally are not otherwise required to be disclosed by the issuer.

We also think it is inherent in this sort of disclosure, particularly given the breadth of the factors to be considered, that the explanation of “critical audit matters” determinations in varying circumstances will fairly call for disclosure of other issuer information. With respect, we don’t think this new and completely open-ended disclosure requirement can fairly be compared (as the Board suggests) to the existing requirements that auditors disclose going concern issues or material weaknesses in internal control over in financial reporting. Rather, we expect that the proposed rules will result in all sorts of new (and unpredictable) disclosure.

For reasons that have been well articulated, we think the issuer should be the original source of any disclosure about the issuer or its results of operations or financial position. Although the auditor will generally have a well-informed perspective on these matters, that perspective is necessarily different from, and narrower than, management’s perspective. Management is responsible for having the “complete picture” and making disclosure accordingly, while the auditor’s knowledge of the issuer derives from what the auditor observes through the course of the audit. But the audit is designed for the specific purpose of supporting the auditor’s report, *not* for the purpose of informing the auditor generally about the issuer and its affairs, or supporting general disclosures about the issuer (whether those disclosures relate to the financial statements or information outside the financial statements). So it seems to us that substantive disclosures about the issuer developed by the auditor inherently reflect a limited perspective, and should not be encouraged, much less required.

In addition, we are concerned that in defining critical audit matters in part by reference to whether a matter was discussed with the audit committee – the proposed rule picks up matters actually communicated, in addition to those required to be communicated, to the audit committee – the new rules are likely to have, as an unintended consequence, a tendency to discourage free and open communication between

the auditor and management and between the auditor and the audit committee. For any number of reasons, issuers and auditors may wish to limit, or otherwise influence, the number of critical audit matters that must be addressed, and seek to do so by limiting such communications. This would obviously be a most unfortunate effect, but we are quite concerned that it will be a consequence of operating under the proposed rules. We are also concerned that discussion of critical audit matters in the auditor's report will lead issuers to feel compelled to make reactive disclosures, resulting in added burdens to issuers and their audit committees. And all of those processes will add time and cost, including the additional audit costs of preparing, discussing and reviewing critical audit matters and the additional issuer costs of preparing and vetting any additional reactive disclosures. At the same time, they will have the effect of causing the auditor to be a source of disclosure about the issuer and its financial reporting rather than solely an independent auditor of the issuer's financial information, thus both changing and blurring the role of the auditor.

We continue to believe it is quite important that issuers (and derivatively, their shareholders) get the full benefit of the auditor's insights acquired through the course of the audit. But we feel strongly that requiring the auditor to make public substantive disclosures about "critical audit matters" will not promote that objective, and may well inhibit the audit and governance processes now in place to oversee financial reporting. Auditors should be encouraged to have the fullest and frankest conversations possible within their firms and with the audit committee. The best way to promote that objective is to allow those conversations to be conducted on a confidential basis. We continue to be quite concerned that if the auditor's discussions within the firm and with the audit committee are conducted with the anticipation of subsequent public disclosures being made by the auditor, these internal and auditor/audit committee discussions may be

seriously inhibited. Auditors may be more cautious in raising concerns, and audit committee members may be more circumspect in probing such concerns with the auditor.

The audit committee, and the board of directors, have oversight responsibility for the issuer's disclosure, including its financial statements. We believe that public company audit committees generally seek to understand and address substantive concerns raised by auditors in the course of their interaction, but to the extent there are concerns about audit committee performance in this regard, that should be addressed as a governance matter, including through additional Commission or stock exchange rule making, if thought necessary, not by requiring auditors to make their own public disclosures about the issuer.

The Release, like the Board's earlier releases, includes extensive discussion of audit report requirements in other countries, including standards of the Internal Auditing and Assurance Standards Board, the European Union and the Financial Reporting Council in the U.K. We do not believe that these requirements reflect the very distinctive governance, disclosure and – perhaps most importantly – liability regimes prevailing in the United States, and therefore we do not think non-U.S. precedent should guide the Commission's decision on the proposed rules. The Commission should determine whether the "critical audit matters" requirements produce an improvement to the quality of information investors of U.S. issuers receive, without undue adverse consequences, in the U.S. context, and not yield to any false sense of inevitability based on practices developing elsewhere.

Based on the foregoing, we would respectfully urge the Commission not to approve the proposed rules in their existing form.

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We appreciate this opportunity to comment on the proposed auditing standard. You may direct any questions with respect to this letter to Robert E. Buckholz at [REDACTED] or Robert W. Downes at [REDACTED].

Very truly yours,

A handwritten signature in cursive script that reads "Sullivan & Cromwell LLP".

SULLIVAN & CROMWELL LLP