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Via Email

August 19, 2017

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number PCAOB-2017-01:

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 (the "Proposal")

Dear Mr. Fields:

General Comments

My comment letter dated August 5, 2016 to the PCAOB on its Release No. 2016-003 (the "reproposal"),[1] contained the reasons I am opposed to the inclusion of Critical Audit Matters ("CAM") and the disclosure of auditor tenure in the auditor's report. My 2016 letter addresses (among other matters):

- the duplication of information that investors already have;
- disclosure of critical accounting policies in MD&A vs. CAM disclosure;
- disclosure of significant accounting policies in financial statements;
- information asymmetry;
- disclosure of confidential and original information (the "unless" clause);
- disclosure of audit steps and procedures;
- CAMs vs. Key Audit Matters,
- auditor tenure;

[1] PCAOB Rulemaking Docket Matter No. 034, Release 2016-003: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, (May 11, 2016), https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf.

- materiality; and
- auditor litigation risk.

As this Proposal is substantially the same as the 2016 reproposal, my 2016 letter is incorporated by reference into this letter and should be read together with the following comments.[2]

For the reasons expressed here and in my 2016 letter, the SEC should not approve this Proposal as to CAMs and auditor tenure.

CAM reporting and the disclosure of auditor tenure is an experiment that, if adopted as proposed, cannot be easily undone short of a provision that this reporting be subject to a vigorous annual review of the costs and benefits to investors. Then, based on this review, such disclosures will be continued, altered or rescinded. Alternatively, such disclosures should be subject to a sunset provision.[3]

Information Asymmetry

The fundamental premise set out in the Proposal is –

> The Board believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management.[4] (Emphasis added.)

This presumption is then repeated two more times in more expansive terms –

> Stated in economic terms, in the Board's view, an expanded auditor's report will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Reducing information asymmetry about the company's financial reporting should lead to a more efficient allocation of capital.[5] (Emphasis added.)

I do not believe anyone questions the first part of the premise – yes, CAM reporting will tell readers of the auditor's report (a) those matters that met the definition of a CAM, (b) why the auditor concluded the matter was a CAM, and (c) in summary form, the audit steps used to

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[2] See my 2016 letter at https://pcaobus.org/Rulemaking/Docket034/059c_Waxman.pdf.

[3] See the request for comments regarding whether the SEC should consider including automatic sunset provisions in new disclosure requirements under Reg. S-K. See Concept Release on Business and Financial Disclosure Required by Regulation S-K (Release No. 33-10064; 34-77599; File No. S7-06-16).

[4] See 82 Fed. Reg. at 35415.

[5] See 82 Fed. Reg. at 35415 and stated again at 35418.

audit the CAM. Also, as an added feature of CAM reporting, investors may read confidential information that had never been previously disclosed by management.[6]

However, it is the next part of the premise that is hypothetical and questionable, i.e., CAMs "should, in turn, reduce the information asymmetry between investors and management." The reproposal and Proposal do not provide any evidence, either factual or empirical, that the reporting of a CAM will reduce the information gap between management and investors such that this information is valuable in making investment decisions and "should lead to a more efficient allocation of capital."

This fundamental premise is an argument by assertion.

I believe that most investors do not actually care about "how the sausage is made,"[7] or what audit steps were undertaken in order to produce the audit report "sausage." CAM and auditor tenure reporting will not reduce the information gap between investors and management, such that it will give investors a useable investment edge or strategy. The Proposal does not reveal how investors will use CAMs and auditor tenure disclosure in their buy, sell and hold investment decisions, or how other users, such as creditors will use these disclosures in lending decisions.

How does reading about some of the audit procedures that were followed in the verification of an account or disclosure increase an investor's knowledge of a company's financial performance, cash flows, intrinsic values, etc., and thus lead to an efficient allocation of capital? The Proposal provides no answer to this basic question.

Information asymmetries between management and investors will be more efficiently and effectively reduced by the disclosure effectiveness project currently underway by The Division of Corporation Finance's review of the disclosure requirements in Regulation S-K and Regulation S-X.[8]

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[6] See AS 3101.14, Note 2: Note 2 stating: "When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit." (Emphasis added.)

[7] See The CPA Journal, July 2016, *The PCAOB's Proposed New Auditor's Report*, Allan B Afterman, CPA. http://www.cpajournal.com/2016/07/06/pcaobs-proposed-new-auditors-report.

[8] See SEC Spotlight: Disclosure Effectiveness at https://www.sec.gov/spotlight/disclosure-effectiveness.shtml.

Economic Considerations

My 2016 letter said that –

> Investors always want more data and more information, especially when it is free. However, every public company will bear some portion of the cost of that information, which cost will be passed on to them by their auditors, and the auditors will in turn reap the monetary benefits of the reproposed CAM reporting.

While the reproposal said "[c]ommenters' views varied significantly about the likely magnitude of direct costs associated with auditor reporting of critical audit matters,"[9] it also stated that in the first year of expanded auditor reporting in the United Kingdom, where there was an audit fee increase, there was an average change in fees of approximately 5 percent. [10] [11] However, it was noted that the PCAOB staff did not analyze the factors that went into the 5 percent increase.

The reproposal pointed out that "[a]cademic research also finds an approximately 4 percent increase in audit fees two years after the implementation of expanded auditor's reporting in the United Kingdom."[12]

I believe audit fees will increase as a result of the additional effort auditors will expend in order to satisfy CAM reporting requirements and documentation, and that CAM reporting will be a profit center for auditors. Using 5 percent as an approximation of this effort, my 2016 letter estimated an increase in audit fees. This estimate assumed those fees can and will be successfully billed to audit clients. My 2016 letter stated –

> For 2014, the average audit fees for 7,071 SEC filing companies were $1,533,438, or $10,842,940,098 in total audit fees.[13] Using the 5 percent cited in the reproposal results in an increase in recurring total audit fees of approximately $542 million … (dollars each year), an average of $76,672 for each of the 7,071 SEC filing companies.

I recognize that the 2015 FERF report did not include data regarding every registrant, nor did it segregate any information for Emerging Growth Companies; however, it was useful in approximating the potential direct cost impact of this Proposal.

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[9] Page 82 of the reproposal.

[10] Page 83 of the reproposal.

[11] This discussion of audit fees in the 2016 reproposal was modified in the 2017 Proposal. The Proposal now says (page 35423 of 82 Fed. Reg.), "Audit fees increased for the remaining companies [47 percent of the companies analyzed]. The PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent, roughly consistent with the findings of academic research described in the economic analysis in the reproposal."

[12] Page 83 of the reproposal, footnote 168.

[13] See the *2015 Audit Fee Report*, Financial Executives Research Foundation (issued October 2015).

The latest 2016 FERF report shows that fees incurred in 2015 for 6,490 SEC filing companies averaged $1,817,003, or $11,792,349,470 in total audit fees.[14] Again, using the 5 percent as an approximation of the additional audit fees resulting from CAM reporting, the increase in recurring total audit fees for these SEC filing companies is $589,617,000, assuming that these fees can be successfully billed to clients over time. This averages to $90,850 for each of the 6,490 above-mentioned SEC filing companies in each year, and further assuming that this "ballpark" cost will be passed on, if not immediately, but eventually.

Even if the fees increased by, say for example 2 ½ percent, the annual cost is nearly $300 million every year. These audit fees may likely increase over time, since auditors will be motivated to expand this profit center.

Robust Economic Analysis Is Needed

The reproposal had not established that the benefits (as yet unknown and unproven) exceed the costs to be borne by all registrants (except EGCs, which are now exempt from this Proposal). The Proposal reports that –

> One commenter asserted that the Board's release did not provide a true economic analysis of the pros and cons of mandating the reporting of critical audit matters, but only referenced academic studies on the purported benefits of such reporting. Another argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs.[15]

The Proposal also states the –

> Board has considered all comments received and has sought to develop an economic analysis that evaluates the potential benefits and costs of the final standard, as well as facilitates comparisons to alternative Board actions.[16]
>
> Board has sought information relevant to economic consequences several times over the course of the rulemaking. Commenters provided views on a wide range of issues pertinent to economic considerations, including potential benefits and costs, but did not provide empirical data or quantified estimates of the costs or other potential impacts of the standard. The potential benefits and costs considered by the Board are inherently

[14] See the *2016 Audit Fee Report*, Financial Executives Research Foundation (issued November 2016).

[15] See 82 Fed. Reg. at 35415 and the letter from the Institute of Management Accountants at https://pcaobus.org/Rulemaking/Docket034/06c_FRC-IMA.pdf.

[16] See 82 Fed. Reg. at 35415.

> difficult to quantify, therefore the Board's economic discussion is primarily qualitative in nature.[17] (Emphasis added.)

At this time, we do not know what additional professional time will be expended in preparing CAM disclosures and documentation, and the fees that professional time will generate. Nevertheless, it is not credible to say that audit fees are negligible or will not increase – we all know that "there is no such thing as a free lunch." There will be a cost to be borne by registrants.

If this Proposal is to be considered for adoption, rather than outsource the economics of this Proposal to the commenters, I believe it is the PCAOB's responsibility to provide a more rigorous and robust economic cost and benefits analysis. To the extent possible and at a minimum, the PCAOB should estimate (a) the additional audit fees that will be incurred by the average registrant resulting from this Proposal, and (b) other direct and indirect costs that may be incurred by registrants. In addition, the other side of this equation, i.e., the benefits should be estimated in monetary terms.

The PCAOB regrettably defaulted to qualitative factors, the Proposal maintaining, "[g]iven lack of data, the Board is unable to quantify costs, but provides a qualitative cost analysis."[18]

Cost Burden Impairs Capital Formation

In today's regulatory and economic environment, as it pertains to CAMs and auditor tenure, this Proposal is an unnecessary regulation. The Proposal increases audit fees, will likely burden registrants with other direct and indirect costs, and therefore will make it costlier to go public, add to the overall cost of raising capital, which would then impair capital formation.[19]

Who Benefits?

The Proposal states –

> The larger and some smaller accounting firms generally supported including critical audit matters in the auditor's report with some modification of the reproposed requirements. Other commenters, including other smaller accounting firms, companies, and audit committee members, did not support the requirements. Some of these commenters asserted that critical audit matters would not provide relevant information to investors, may be duplicative of the company's disclosure, may result in disclosing information not otherwise required to be disclosed, could increase cost, or could delay completion of the audit.[20]

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[17] See 82 Fed. Reg. at 35415.

[18] See 82 Fed. Reg. at 35422.

[19] See pages 61-63 of the reproposal.

[20] See 82 Fed. Reg. at 35397-35398

It is understandable that the larger accounting firms have a strong incentive to support the Proposal since they are the beneficiary of the increase in audit fees. Further, it is equally clear that audit committee members and company management would not support this Proposal, as they know among other things (a) they will be bear the costs of this Proposal with no measurable discernible benefits, and (b) the Proposal subverts corporate governance including the audit committees oversight role.[21]

<u>Change Our Vocabulary</u>

The Proposal instructs auditors –

> If the auditor chooses to describe audit procedures, the descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, as the four examples should make clear, the objective is to provide a useful summary, not to detail every aspect of how the matter was addressed in the audit. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.[22]

Auditors are asked to translate the language and words they have used for decades into some other easier to digest non-technical words when describing CAMs and audit procedures.[23] If the average investor truly wants to understand this new auditor's report then they should "learn the language."

<u>Lack of Guidance</u>

The reproposal contained two illustrations of CAM disclosure. Those illustrations were deficient in that they did not provide any information about the company that was not already required to be publicly disclosed by management under existing SEC and GAAP rules. It is noted that these two illustrations were deleted in the Proposal "because the Board believes auditors should provide tailored, audit-specific information when communicating critical audit matters in the auditor's report."[24]

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[21] Since the PCAOB did not disclose their detailed analysis of the comment letters received, we do not know just how many larger accounting firms, how many audit committees and companies support, or did not support, the reproposal (and its predecessor proposals).

[22] See 82 Fed. Reg. at 35403.

[23] See EXHIBIT 2 to my letter for a listing of "technical" audit procedures found in audit reports issued under the IAASBs Standard related to Key Audit Matters (KAMs), under paragraph 13 of ISA 701.

[24] See 82 Fed. Reg. at 35402, footnote 19.

After the concept release (2011), two proposals (2013 and 2016), and hundreds of examples of opinions with KAM disclosures issued under ISA 701, it is disappointing that this final Proposal lacks guidance and that such guidance perhaps may only come after adoption and pursuant to the PCAOB's monitoring, as next discussed.

<u>Monitoring Its Own Baby</u>

The Proposal says that the Board intends to monitor the implementation of the final standard, determine if there are unintended consequences, and if additional guidance or "enhancements" are needed.

Now, six years after this project began, is not the time to begin learning how this Proposal will be executed and what additional guidance or enhancements are needed. This Proposal is not long overdue, as some say, it is an experiment that should never have been hatched.

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I appreciate your consideration of my comments on this Release. If you have any questions please call me at the number below.

Sincerely,

Robert N. Waxman, CPA
[redacted]