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PCAOB Proposes New Auditing Standards Relating to the Audit Report and Auditor Responsibilities Regarding Other Information in Annual Reports

TODD E. FREIER, JONATHAN A. KOFF, AND WILLIAM M. LIBIT

The authors of this article discuss the Public Company Accounting Oversight Board's proposed auditing standards aimed at increasing the informational value of the audit report to promote the usefulness and relevance of the audit and the related audit report.

On August 13, 2013, the Public Company Accounting Oversight Board (the “PCAOB”) proposed two auditing standards aimed at increasing the informational value of the audit report to promote the usefulness and relevance of the audit and the related audit report. If adopted as proposed, the new auditing standards will be (1) applicable to audits of reporting companies, brokers and dealers, investment companies, and employee stock purchase, savings and similar plans, and (2) effective for audits of financial statements for fiscal years beginning on or after December 15, 2015. The PCAOB is seeking comment on the proposed auditing standards described in PCAOB Release No. 2013-005.¹

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BACKGROUND

Over the past three years, the PCAOB conducted extensive outreach with investors, auditors, financial statement preparers and other regulators and interested parties to better understand the nature of improvements that could be made to the audit report to make it more informative.² During the PCAOB's outreach, many investors and other audit report users (1) expressed dissatisfaction that the content of the existing audit report provides little, if any, information specific to the audit of the company's financial statements, (2) indicated that they would benefit from additional auditor reporting, and (3) indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the audit report to make the reports more useful.

As a result of its outreach, the PCAOB proposed the following two auditing standards to enhance (1) information contained in the audit report (the "Proposed Auditor Reporting Standard"), and (2) the auditor's responsibility with respect to "other information" contained in a company's annual report that includes the company's audited financial statements (the "Proposed Other Information Standard"):

PROPOSED AUDITOR REPORTING STANDARD

The Proposed Auditor Reporting Standard would make certain significant changes to the existing audit report, including:

- Requiring the auditor to communicate in the audit report critical audit matters that were addressed during the audit. If the auditor determined that there were no critical audit matters, the auditor would state such conclusion. "Critical audit matters" are defined as those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments, (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. The discussion relating to the critical audit matters in the audit report would (a) identify the critical audit matter, (b) describe the considerations that led the auditor to determine that the matter is a criti-

cal audit matter, and (c) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. The Proposed Auditor Reporting Standard includes a list of factors the auditor should take into account in determining critical audit matters.

- Adding new elements to the audit report related to (1) auditor independence (including a statement regarding the auditor's existing requirements to be independent of the company, in accordance with federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission (the "SEC") and the PCAOB), (2) auditor tenure (including a statement disclosing the year the auditor began serving as the company's auditor), and (3) other information (including a statement relating to the auditor's responsibilities for, and the results of, the auditor's evaluation of other information in annual reports filed with the SEC containing the audited financial statements).
- Enhancing certain standardized language in the audit report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.

The Proposed Auditor Reporting Standard would retain the pass/fail model of the existing audit report as to whether the financial statements are fairly presented (e.g., the auditor would issue an unqualified opinion (pass) if the financial statements are fairly presented or a qualified opinion, adverse opinion or disclaimer of opinion (fail) if such statements are not so presented). The Proposed Auditor Reporting Standard would also retain explanatory paragraphs that are required in certain circumstances and the auditor's ability to emphasize a matter in the financial statements. An illustrative auditor's unqualified report containing applicable provisions of the Proposed Auditor Reporting Standard appears in Appendix 1 to PCAOB Release No. 2013-005 and follows on the next two pages.

An Illustrative Auditor’s Unqualified Report

(PCAOB Release No. 2013–005, Appendix 1, Pages A1-15 through A1-16)

[Changes from the current illustrative report are underlined]

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Introduction]

We have audited the accompanying balance sheets of X Company (the “Company”) as of December 31, 20X2 and 20X1, the related statements of operations, stockholders’ equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes (collectively referred to as the “financial statements”). These financial statements are the responsibility of the Company’s management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board (“PCAOB”) (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission (“SEC”) and the PCAOB. We or our predecessor firms have served as the Company’s auditor consecutively since [year].

[Basis of Opinion]

Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

[Opinion on the Financial Statements]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of *[at]* December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with *[the applicable financial reporting framework]*.

Critical Audit Matters

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

[Include critical audit matters]

The Auditor's Responsibilities Regarding Other Information

In addition to auditing the Company's financial statements in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on *[SEC Exchange Act form type]* filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[Signature]

[City and State or Country]

[Date]

PROPOSED OTHER INFORMATION STANDARD

The Proposed Other Information Standard, among other things, would:

- Enhance the auditor’s responsibility with respect to other information contained in a company’s annual report (that includes the company’s audited financial statements) filed with the SEC under the Securities Exchange Act of 1934. “Other information” in such context is described as information, other than the audited financial statements and the related audit report, included in the company’s annual report. Other information would include, among other items, Risk Factors, Selected Financial Data, Management’s Discussion & Analysis, exhibits and certain information incorporated by reference. The Proposed Other Information Standard includes procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit. Consequently, such evaluation will likely be limited to information directly related to the company’s financial statements. The PCAOB’s existing standard has no requirement for the auditor beyond “read and consider” with respect to the other information. In contrast, the Proposed Other Information Standard includes procedures that auditors would consistently perform in evaluating the other information.
- Require the auditor to evaluate the other information for a material misstatement of fact, as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements.
- Require communication in the audit report regarding the auditor’s responsibilities for, and the results of, the auditor’s evaluation of the other information.

POTENTIAL COSTS TO COMPANIES AND INCREASED BURDEN ON AUDIT COMMITTEES

The PCAOB anticipates that the proposed auditing standards would likely result in additional costs for companies and impose an increased bur-

den on audit committees. For example, companies could incur additional recurring costs as a result of the Proposed Auditor Reporting Standard, including increased audit fees due to the new reporting requirements. Further, companies might incur one-time costs in developing, and recurring costs in performing, internal processes for the review of critical audit matters in the draft audit report and incur additional costs related to corresponding interactions with auditors. The additional duties and responsibilities relating to the review of critical audit matters to appear in the audit report and corresponding discussions with the auditor and management may also impose an increased burden on audit committees.

WHAT SHOULD I DO NOW?

The PCAOB seeks comment on the proposed auditing standards, including on the specific questions presented in Appendices 5, 6 and 7 to PCAOB Release No. 2013-005 and on corresponding economic considerations (including the potential costs to companies and increased burden on audit committees to implement and effectuate the proposed standards).

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by email to comments@pcaobus.org or through the PCAOB's Web site at pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 034 in the subject or reference line and must be received by the PCAOB no later than 5:00 p.m. (EST) on December 11, 2013.

NOTES

¹ See http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf.

² The audit report is the primary means by which an auditor communicates to investors and other financial statement users information regarding the audit of a company's financial statements. Currently, the report (1) identifies the financial statements that were audited, (2) describes the nature of the audit and (3) presents the auditor's opinion as to whether the financial statements fairly present, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework.