The PCAOB Proposes Amendments to the Auditor's Reporting Model

On June 21, 2011, the Public Company Accounting Oversight Board ("PCAOB") issued a concept release to solicit public comment on proposed changes to the auditor's reporting model.[1] The proposals, obtained through the Board's outreach efforts to financial statement users,[2] are intended to increase the transparency and relevance of the auditor's report "by improving the content of the auditor's report rather than on changing the fundamental role of the auditor"[3] and include:

(1) the addition of an "Auditor's Discussion and Analysis" ("AD&A"),

(2) required and expanded use of "emphasis paragraphs,"

(3) required reporting on information outside the financial statements, and

(4) clarification of certain language in the existing standard auditor's report.[4]

Implementing any or all of these proposals may result either in amendments to PCAOB Interim Standard AU sec. 508 and AS No. 1 or the development of a new auditing standard.[5] The PCAOB is seeking comment on its proposed standards through September 30, 2011.

I. The Current Standards Governing Audit Reports

Under Rule 2-02 of Regulation S-X, a public company is required to submit an auditor's report with respect to its financial statements in its periodic filings with the Securities and Exchange Commission ("SEC").[6] Per AU sec. 508, the report for an "unqualified opinion"[7] follows a concise, three-paragraph format in which the auditor "identif[ies] the financial statements audited in the introductory paragraph, describe[s] the nature of [the] audit in the scope paragraph, and include[s its] opinion in the opinion paragraph."[8] The standard requires an additional explanatory paragraph only under certain circumstances, such as when "there is substantial doubt about

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1 *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements*, Release No. 2011-003 (Jun. 21, 2011) (the "Concept Release"), available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

2 "Financial statement users" include, among others, investors, auditors, financial statement preparers, and audit committee members. *Concept Release* at 3.

3 *Id.*

4 *Id.* at 2–3. "These alternatives are not mutually exclusive." *Id*. at 2.

5 *Id*. at 2 (citing AU sec. 508, *Reports on Audited Financial Statements* and AS No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*).

6 *See* 17 C.F.R. § 210.2-02 (2010).

7 There are four types of opinions that an auditor may issue in connection with an audit of financial statements including an "unqualified opinion," "qualified opinion," "adverse opinion," and "disclaimer of opinion." AU sec. 508. However, the "unqualified opinion" is considered the "standard auditor's report" for the purposes of this discussion since the SEC does not accept qualified, adverse, or disclaimer opinions. *Concept Release* at B-2.

8 *Concept Release* at B-1 (summarizing the requirements of AU sec. 508 and AS No. 1). "The standard auditor's report has been commonly described as a pass/fail model because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail)." *Id.* at 3.

[a] company's ability to continue as a going concern . . . [and when] there has been a correction of a material misstatement in previously issued financial statements."[9] Furthermore, "emphasis paragraphs" are never required, but may be used at the auditor's discretion to report "significant transactions with related parties," "unusually important subsequent events," and "specific accounting matters affecting the comparability of financial statements."[10]

II. Audit Reports under the Proposed Alternatives

A. Auditor's Discussion and Analysis

The "most expansive" of the proposed alternatives is the AD&A—a new, narrative section of the auditor's report in which the auditor would comment on the quality of a company's financial statements and audit process.[11] The PCAOB proposes that the AD&A could include an analysis of "audit risk" identified in a company's audit as well as a discussion of the auditor's independence and the company's audit procedures and results.[12] Furthermore, the AD&A could include an auditor's views on management's judgments and estimates, accounting policies, and potential "contentious issues," including "close calls."[13] Finally, the PCAOB contemplates that the AD&A could be used to disclose and discuss "material matters that might be in technical compliance with the applicable accounting framework" and are therefore not disclosed under the current standard, yet are of interest to investors who seek an improved understanding of how a company's accounting policies and procedures affect its financial statements.[14]

The PCAOB believes that the AD&A, by providing additional discussion and disclosure of significant accounting matters, may better inform "an investor's understanding of a company's financial statements and management's related discussion and analysis . . . ."[15] Additionally, it is possible that the "AD&A could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors."[16] For example, an auditor's perspective on certain accounting matters in its AD&A may differ from management's own assessment.[17] This might compel the company's management and audit committee to seek resolution with the auditors before the AD&A and Management Discussion and Analysis ("MD&A") are disclosed in a public filing and any differences or disagreements are therefore transmitted to investors.[18]

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9 *Id*. at B-2 (citing AU sec. 508.11).

10 *Id.* (citing AU sec. 508.19).

11 *Id.* at 13–14.

12 *Id*. at 13 & n.18. "Auditing Standard No. 8, *Audit Risk*, describes audit risk as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated." *Id*. at 13 n.18.

13 *Id*. at 13.

14 *Id*.

15 *Id*.

16 *Id*.

17 *Id*. at 14.

18 *Id.* The MD&A is a required section of a company's public filings in which management provides a narrative of a company's operational and financial performance. Topics discussed in a typical MD&A include, among others, a company's liquidity position, capital resources, results of operations, off-balance sheet arrangements, and events of unusual or infrequent nature. *See* Item 303 of Regulation S-K, 17 C.F.R. 229.303 (2010).

B. Required and Expanded Use of Emphasis Paragraphs

The PCAOB further proposes to make "emphasis paragraphs" a required component of the auditor's report.[19] By highlighting significant accounting matters and referencing where those matters are disclosed in a firm's financial statements, emphasis paragraphs may improve financial statement users' understanding of financial information. The use of emphasis paragraphs is suggested under current standards, and may become mandatory under the PCAOB's proposals, in situations where:

- the audited entity is a component of a larger business enterprise;
- the entity has entered into significant transactions with related parties;
- an "unusually important" event has occurred subsequent to the production of the financial statements; and
- the financial statements are no longer comparable with those of previous periods for reasons not relating to a change in accounting principles.

The PCAOB also envisions that the required use of emphasis paragraphs would address:

- significant management judgments and estimates;
- areas with significant measurement uncertainty; and
- other areas that the auditor determines are important for a better understanding of the financial statement presentation.[20]

C. Auditor Assurance on Other Information Outside the Financial Statements

The PCAOB's third proposal would increase the scope of auditors' responsibilities, requiring them to provide assurances on references to financial information found outside the audited financial statements.[21] Motivating this proposal are the PCAOB's findings that "investors use and rely on MD&A and other [unaudited] financial information . . . for their investing decisions . . . ."[22] Therefore, requiring auditors to provide assurances on this information "could make an audit and auditor reporting more relevant to investors and other users of financial statements"[23] by "improv[ing] the quality, completeness, and reliability of such information."[24]

The PCAOB suggests that the new auditor assurance standard be modeled after its "attest standard," which currently applies in situations where an auditor is retained specifically to review an MD&A.[25] Under the

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19 *Id*. at 19–21.

20 *Id*. at 20.

21 *Id*. at 22–23.

22 *Id.* at 22.

23 *Id*. at 23.

24 *Id*. at 22.

25 *See id*. at 23–24; AT sec. 701.

attest standard, the auditor must evaluate the quality and completeness of the MD&A presentation, taken as a whole, by reporting on whether (1) the presentation includes the required elements of rules and regulations adopted by the SEC in all material respects, (2) historical financial amounts have been accurately derived from the entity's financial statements in all material respects, and (3) underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein. Pursuant to the new assurance standard, auditors may have the obligation to attest to "earnings releases, non-GAAP information, the entire MD&A, or portions thereof."[26]

D. Clarification of the Standard Auditor's Report

The final potential enhancement would involve amending, and possibly adding language to, the standard auditor's report to provide a clearer "explanation about what an audit represents and the related auditor responsibilities."[27] Examples of terms or concepts that may require clarification include:

- Reasonable Assurance: The standard auditor's report includes a statement that the auditor must "plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of material misstatement,"[28] yet does not define "reasonable assurance." The PCAOB proposes that auditors further explain this term, potentially by defining it as being "a high level of assurance, but not absolute assurance" in accordance with the current accounting standards.[29]

- Auditor's Responsibility for Fraud: The standard auditor's report is silent about the auditor's responsibility to detect fraud under AU sec. 230. Language may be added to the auditor's report that clarifies the auditor's responsibility to plan and perform an audit "to obtain reasonable assurance about whether the financial statements are free of material misstatement" due to fraud.[30]

- Auditor's Responsibility for Financial Statement Disclosures: Auditing standards require auditors to evaluate whether the financial statements are fairly presented and conform to the financial reporting framework. Additionally, auditors must "identify and test significant disclosures,"[31] assess the risk of omitted, incomplete or inaccurate disclosures, and, in integrated audits, test controls over significant disclosures. These responsibilities could be outlined in financial statement disclosures.

- Management's Responsibility for the Preparation of Financial Statements: Although auditors are responsible for expressing opinions on company financial statements, new auditing standards may require clarification that ultimate responsibility for the preparation and fair presentation of the financial statements lies with company management.

- Auditor's Responsibility for Information Outside the Financial Statements: New auditing standards may require that the auditor's report explicitly mention the auditor's responsibility to consider

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[26] *Id.* at 24.

[27] *Id.* at 27.

[28] *Id*. (emphasis added).

[29] *Id.*

[30] *Id.*

[31] *Id*. at 28.

whether any information presented alongside financial statements "is materially inconsistent with the financial statements or represents a material misstatement of fact."[32]

- Auditor Independence: Although current regulations require auditors' independence from the companies they are auditing, this is not made clear in the standard auditor's report. The PCAOB proposes that audit reports include a mandatory statement regarding auditors' independence.

III. Concerns Regarding More Expansive Disclosure Standards

The PCAOB also seeks comment on potential "challenges and unintended consequences" arising from its proposals. Through its outreach efforts, the PCAOB has identified several potential areas of concern:[33]

A. Cost of Audit Effort

Financial statement users are concerned that requiring more robust auditor reporting will significantly increase the cost of completing an audit. Non-standardized reports will invariably take more time to create, and auditors will have to both train their employees on how to create such reports and put in place a "quality control" system to ensure that there is consistency among reports produced for different clients. The increase in time necessary for management, the auditor, and the audit committee to discuss the nature and extent of the information in the audit could negatively impact the auditor's ability to meet public reporting deadlines. It might also expand the scope of the auditor's responsibilities, resulting in the implementation of additional requirements and procedures.

B. Openness and Transparency in Auditors' Relationships

There is also a concern that a stronger auditor reporting standard may stifle communication between the auditor, management, and the audit committee, undermining the openness and transparency central to effective disclosure. The PCAOB notes, for example, that "comments or presentations made in private, such as in an audit committee executive session or an audit committee communication, could be tempered if the speakers or recipients have concerns that such comments or presentations could eventually become public."[34] Additionally, management and the audit committee may be compelled to change a company's financial statements in order to eliminate any differences that may exist with the auditor's AD&A.

C. Liability Considerations

The PCAOB also recognizes that "changes to the auditor's reporting model could result in increased liability for auditors and issuers," particularly under Section 11 of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and various state laws.[35] Liability may arise from the disclosure of new and different types of information about a company's financial statements and audit process. Furthermore, the complexity of the auditor's report may confuse certain investors who are unsure of how to interpret financial

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32 *Id*. at 28–29.

33 *Id*. at 31–34.

34 *Id*. at 32.

35 *Id*. at 33.

statements or the meaning of an "unqualified opinion" under the new standard, thereby "resulting in negative market reaction that could, in turn, lead to litigation against the issuer or auditor."[36]

D. Disclosure of Confidential Information

Other outreach participants are concerned that new audit reporting standards might increase the risk of disclosing information "deemed proprietary or highly sensitive to the company's competitive industry position."[37] These participants have encouraged the PCAOB "to consider maintaining the confidentiality of company information" as it contemplates changes to the auditor's report.[38]

E. Effect on Corporate Governance

Finally, the PCAOB recognizes financial statement users' concern that requiring auditors to provide an in-depth narrative to investors may undermine the role of the audit committee—the corporate entity currently responsible for overseeing the communication of financial information to investors.

IV. Conclusion

Through its proposed changes to the auditor reporting model, the PCAOB is attempting to improve the transparency and relevance of the auditor's reporting model to investors and other financial statement users without compromising audit quality. The PCAOB now seeks comment on its proposals, and any other possible alternatives, as well as the potential effects of its proposed alternatives. The concerns identified by the PCAOB are significant and will likely elicit numerous comments.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Yafit Cohn at 212.701.3089 or ycohn@cahill.com.

36 *Id.*

37 *Id.*

38 *Id.*

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