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# Comments by the Auditing Standards Committee of the Auditing Section of the American Accounting Association on the PCAOB...

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CONCEPT RELEASE ON POSSIBLE  
REVISIONS TO PCAOB STANDARDS  
RELATED TO REPORTS ON AUDITED  
FINANCIAL STATEMENTS

AND RELATED AMENDMENTS TO PCAOB  
STANDARDS

NOTICE OF ROUNDTABLE

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)  
) PCAOB Release No. 2011-003  
) June 21, 2011  
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) PCAOB Rulemaking  
) Docket Matter No. 34  
)

**Summary:** The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing a concept release to solicit public comment on the potential direction of a proposed standard-setting project on the content and form of reports on audited financial statements. The Board will also convene a public roundtable meeting in the third quarter of 2011, at which interested persons will present their views. Additional details about the roundtable will be announced at a later date.

**Public**

**Comment:** Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted via email to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 34 in the subject or reference line. Comments should be received by the Board no later than 5:00 PM EDT on September 30, 2011.

**Board**

**Contacts:** Martin F. Baumann, Chief Auditor (202/207-9192, [baumannm@pcaobus.org](mailto:baumannm@pcaobus.org)), Jennifer Rand, Deputy Chief Auditor (202/207-9206, [randj@pcaobus.org](mailto:randj@pcaobus.org)), and Jessica Watts, Associate Chief Auditor (202/207-9376, [wattsj@pcaobus.org](mailto:wattsj@pcaobus.org)).

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**I. Purpose**

The Board is issuing this concept release to seek public comment on potential changes to the auditor's reporting model based on concerns of investors and other financial statement users. Auditors, as a result of the performance of required audit procedures, often have significant information regarding a company's financial statements and the audit of such financial statement, that is not today reported in the standard auditor's report to the financial statements users. This information might be useful to investors and other financial statement users and could lead to more efficient markets and improved allocations of capital.

The auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his or her audits of financial statements. This concept release seeks direction and comment for a possible standard-setting project that could result in either amendments to AU sec. 508, *Reports on Audited Financial Statements*, and Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*,<sup>1/</sup> or the development of a new auditing standard that would supersede or amend the Board's current standards on auditors' reports.

The objective of this concept release is to discuss several alternatives for changing the auditor's reporting model that could increase its transparency and relevance to financial statement users, while not compromising audit quality. To that end, these alternatives include (1) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements (an "Auditor's Discussion and Analysis"), (2) required and expanded use of emphasis paragraphs in the auditor's report, (3) auditor reporting on information outside the financial statements, and (4) clarification of certain language in the auditor's report. These alternatives are not mutually exclusive. A revised auditor's report could include one or a combination of these alternatives or elements of these alternatives. Additionally, there may be other alternatives to consider that this concept release does not present.

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<sup>1/</sup> Potential changes to the standard auditor's report might result in amendments to the report on internal control included in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. In an integrated audit, information related to the audit of the company's financial statements discussed in this concept release could also include matters related to the audit of internal control over financial reporting.

Many of these alternatives are focused primarily on enhancing communication to investors through improving the content of the auditor's report rather than on changing the fundamental role of the auditor in performing an audit of financial statements in accordance with PCAOB standards as established and interpreted by the Board. However, depending on the nature and extent of additional information to be communicated by the auditor in the auditor's report, new auditing requirements and coordination with the Securities and Exchange Commission ("SEC") would likely be necessary. Further, certain alternatives might result in an increase in the scope of audit procedures beyond those currently required. An increase in the scope of audit procedures would require new auditing standards.

This concept release also describes the history of the auditor's report, as well as the results of outreach conducted by the staff of the Board's Office of the Chief Auditor ("staff") to investors, auditors, financial statement preparers, audit committee members, and others. The outreach was undertaken to obtain insight into possible changes that could be made to the auditor's reporting model. This concept release does not include an exhaustive discussion of all views regarding the auditor's reporting model. Rather, it presents the salient views obtained on possible changes to the auditor's report and other considerations as part of the staff's outreach and which inform this solicitation of comment on possible changes to the auditor's report.

In addition to inviting comments in response to a number of specific questions, the Board invites any interested person to provide comments on any issues related to topics discussed in this concept release or directed at improving the auditor's reporting model. The Board will hold a public roundtable in the third quarter of 2011 to discuss the alternatives addressed herein or other alternatives. Additional details about the roundtable will be announced at a later date.

## **II. History and Outreach**

For decades, the standard auditor's report has identified the financial statements that were audited, described the nature of the audit, and presented the auditor's opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. 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).

This section of the concept release provides a brief history of the auditor's report and a summary of the outreach recently conducted by the staff.

## A. History

In the 1940s, a standardized form of the auditor's report was adopted to provide uniform report language that would make audit reports more readily comparable and make qualifications in audit reports easily recognizable. For more than half a century, many groups have considered changes to the standard auditor's report to enhance the auditor's overall communication to financial statement users. For example, in 1974, the Commission on Auditors' Responsibilities<sup>2/</sup> ("Cohen Commission"), and in 1985, the National Commission on Fraudulent Financial Reporting<sup>3/</sup> ("Treadway Commission"), reexamined both the auditor's responsibilities and the form of the auditor's report. The Cohen Commission noted that "evidence abounds that communication between the auditor and users of his work – especially through the auditor's standard report – is unsatisfactory." These commissions made many recommendations to change the auditor's report; however, the only change resulting from the recommendations was the addition of a paragraph explaining the scope of the audit.<sup>4/</sup> There have been two changes to the standard auditor's report since the 1980s: the adoption of Auditing Standard No. 1 that requires reference to the standards of the PCAOB, and the

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<sup>2/</sup> In response to congressional and public scrutiny of the accounting profession, the American Institute of Certified Public Accountants ("AICPA") established the Commission on Auditors' Responsibilities (known for its chairman as the "Cohen Commission") to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors." The Cohen Commission was directed to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish." AICPA, *Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (New York: 1978), p. xi.

<sup>3/</sup> The Treadway Commission was established in June 1985 during a period of congressional and public scrutiny of the accounting profession after certain significant business failures. See SEC Speech: "The Treadway Commission Report: Two Years Later," by Joseph A. Grundfest and Max Berueffy (January 26, 1989). From October 1985 to September 1987, the Treadway Commission studied the financial reporting system in the United States. The Treadway Commission's mission "was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." *Report of the National Commission on Fraudulent Financial Reporting* (October 1987), p. 1 ("Treadway Commission Report").

<sup>4/</sup> Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts to Influence the Auditing Standards Board*, 1 (Greenwich, CT: JAI Press Inc., 1993), p. 38.

establishment of requirements for auditors to report on internal control over financial reporting as directed by Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act").<sup>5/</sup>

More recently, members of the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG") suggested, and the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") recommended, that the Board undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.<sup>6/</sup> Results of surveys conducted by the Chartered Financial Analysts Institute ("CFA") in 2008, 2010, and 2011, support these suggestions. In particular, the majority of survey respondents noted that the independent auditor's report needed to provide more specific information about how the auditor reaches his or her opinion on whether the company has fairly presented its financial statements in accordance with the required financial reporting standards.<sup>7/</sup>

Additionally, other standard-setters and regulators, such as the International Auditing and Assurance Standards Board ("IAASB"),<sup>8/</sup> the International Organization of Securities Commissions ("IOSCO"),<sup>9/</sup> the United Kingdom's Financial Reporting Council

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<sup>5/</sup> Auditing Standard No. 5, which superseded Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, establishes requirements for auditors to report on internal control over financial reporting.

<sup>6/</sup> U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008), available at: <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>.

<sup>7/</sup> CFA Institute, *Independent Auditor's Report Survey Results* (February 2008, March 2010, March 2011), available at: [www.cfainstitute.org/Survey/independent\\_auditors\\_report\\_survey\\_results.pdf](http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf).

<sup>8/</sup> The IAASB has an active project on the auditor's report. On May 16, 2011, the IAASB issued a consultation paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, available at: <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0163> ("IAASB's Consultation Paper").

<sup>9/</sup> Technical Committee of IOSCO, *Auditor Communications: Consultation Report* (September 2009), available at: <http://www.iosco.org/library/index.cfm?CurrentPage=2&section=pubdocs&criteria=none&year=2009&rows=10>.



("FRC"),<sup>10/</sup> and the European Commission have been working on similar projects to consider changes to the auditor's report.<sup>11/</sup>

The Board is evaluating the PCAOB's auditing standards for reporting on audited financial statements in response to investors' and other financial statement users' historical concerns, including recent concerns highlighted by the financial crisis related to preparing and auditing financial statements for complex global businesses, as well as the active international debate in this area. (See Appendix A for a more detailed discussion of the history of the auditor's reporting model; and see Appendix B for an overview of current auditor reporting requirements pursuant to PCAOB standards.)

## **B. Overview of the Staff's Outreach**

To obtain insight into the changes that investors and others are seeking to the auditor's report and how those changes could be incorporated into the auditor's report or the overall auditor's reporting model, the staff conducted outreach to investors, preparers, auditors, audit committee members, regulators and standard-setters, and representatives of academia from October 2010 through March 2011. The participants in the staff's outreach represented a diverse group of domestic and international organizations and companies, ranging in size from small to large entities. The investors included individuals representing money managers, asset management funds, pension funds, wealth management funds, and organizations that represented institutional investors; investor advocates; buy- and sell-side analysts from some of the largest investment firms; and analysts from the largest credit rating agencies. The dialogue among the outreach participants helped to inform the staff regarding potential changes in the auditor's report, and how those changes could be presented, as well as the benefits and challenges of making such changes. Additionally, the staff read and reviewed publicly available information related to the auditor's reporting model from U.S. and international sources, including academic research, surveys, and other publications, as well as auditors' reports from more than 30 other countries.

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<sup>10/</sup> FRC, *Effective Company Stewardship. Enhancing Corporate Reporting and Audit* (January 2011), available at: <http://www.frc.org.uk/press/pub2485.html>.

<sup>11/</sup> European Commission, *Green Paper. Audit Policy: Lessons from the Crisis* (October 2010), available at: [http://ec.europa.eu/internal\\_market/auditing/otherdocs/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/otherdocs/index_en.htm).

The staff reported its findings to the Board at an open meeting on March 22, 2011.<sup>12/</sup> The Board concluded from this outreach that changing the auditor's report could hold the key to the relevance of the auditor's reporting model. The findings from the outreach are summarized in the following two sections regarding the content and the form of the auditor's report and are discussed in more detail in Appendix C.

## 1. Content of the Auditor's Report

During the staff's outreach, many investors expressed their belief that the audit is a valuable process. The staff observed that there was consensus among investors that the auditor has significant insight into the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful. Investors varied in their views on the types of information, as well as the level of detail that should be included in the auditor's report. Investor perspectives often were influenced by their role in the capital markets (i.e., retail investors, institutional investors, issuers making decisions regarding potential acquisitions) and how they intended to use that information for making investment decisions.

During the staff's outreach, many investors indicated that the auditors are in a unique position to provide relevant and useful information, because of the auditors' extensive knowledge of the company and industry obtained through the audit process and the auditors' experiences with other companies in similar industries. Some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party. The recent financial crisis was cited as an example of a situation in which expanded auditor reporting in advance of the crisis might have been helpful in assessing the quality of the financial statements, and providing early warning signals regarding potential issues by, for example, including a discussion of off-balance sheet contingencies or the sensitivity of loan loss estimates.

During the staff's outreach, some consistent themes emerged. Some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the risks of material misstatement in a company's financial statements.<sup>13/</sup>

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<sup>12/</sup> PCAOB Board Meeting. March 22, 2011, available at: [http://pcaobus.org/News/Events/Pages/03222011\\_OpenBoardMeeting.aspx](http://pcaobus.org/News/Events/Pages/03222011_OpenBoardMeeting.aspx).

<sup>13/</sup> Auditing Standard No. 8, *Audit Risk*, states that the "risk of material misstatement" refers to the risk that the financial statements are materially misstated and provides further discussion about the term "risk of material misstatement."



Additionally, some investors indicated that the auditor should provide information about the company's financial statements, such as the auditor's views regarding the quality of the company's financial statements. Because accounting frameworks provide for significant management judgments and estimates in the company's application of accounting policies and practices, these judgments and estimates could be susceptible to management bias. Since reasonable estimates might vary significantly, there could be a wide range of acceptable results within a company's applicable financial reporting framework. Further, this range of acceptability is not mentioned in the auditor's report and might not be fully reflected in the financial statements. Some investors believed that more relevant insight into the financial statements, through the eyes of the auditor, might better enable them to assess how changes in the economy might affect a company's future financial performance or condition.

Some participants in the staff's outreach recommended expanding the auditor's reporting model to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis ("MD&A"), earnings releases, or non-GAAP information. The basis of this recommendation is that this type of financial information is often highly relevant to investment decisions, and that auditor association may increase the quality and reliability of such information. Finally, some participants in the staff's outreach suggested that certain language within the standard auditor's report should be further clarified or explained to improve the financial statement user's understanding of what an audit represents and the responsibilities of the auditor and management in the audit and financial reporting process.

Some preparers, auditors, and audit committee members also expressed concern regarding certain changes to the auditor's report. For example, some indicated that an auditor's discussion about matters related to the audit (e.g., significant risks and related audit procedures) might be taken out of context without the benefit of the related dialogue about these matters among management, auditors, and the audit committee.

Most preparers, auditors, and audit committee members indicated in the staff's outreach that management or the audit committee, rather than the auditor, should provide additional information about the company; although, there were some who expressed less concern about the auditor providing this type of information. Additionally, some expressed concern that if the auditor were required to communicate information about the company in the auditor's report, the communication among auditors, preparers, and audit committee members might suffer as a result. They pointed out that as part of the audit, auditors have regular and free-flowing dialogue with management and the audit committee. They also cautioned that if the auditor were to provide additional information, then the nature and candor of that dialogue could be affected, with adverse consequences for the audit. Some preparers and audit committee

members also are concerned that auditor discussion about the company's financial statements may blur the lines regarding the roles of the auditor, preparer, and the audit committee as it relates to financial reporting.

Some preparers, auditors, and audit committee members also expressed a concern that auditor discussion about the financial statements could differ from the disclosures that management provides, and therefore might not convey a consistent communication to investors, which could result in confusion. These outreach participants pointed out that when an unqualified opinion is issued, all material matters related to an audit have been resolved; therefore, they stated that additional discussion in the auditor's report is unnecessary, or even potentially misleading.

## 2. Form of the Auditor's Report

In periodic filings with the SEC, companies are required to include an auditor's report with respect to the company's financial statements.<sup>14/</sup> Many investors indicated that the pass/fail model and standardized language of the auditor's report provides consistency, comparability, and clarity of auditor reporting. However, many of these investors indicated that the standard auditor's report is too "boilerplate," does not convey the significant judgments made by the auditor in forming the audit opinion, and limits the auditor's ability to convey to the investor the subtleties that underlie the opinion in his or her report on the company's financial statements. Accordingly, many of these investors supported a reporting format in which a standard auditor's report is retained, with certain language in the report clarified, but supplemented with discussion by the auditor about the audit and the company's financial statements.

Some investors indicated that the standard auditor's report does not provide the auditor with the necessary leverage to effect appropriate change in the company's financial statements. While the auditing standards allow for circumstances in which the auditor can provide emphasis of certain matters,<sup>15/</sup> explanatory language regarding certain matters,<sup>16/</sup> a qualification, or even a disclaimer of the opinion, these options, when used, are not effective in providing transparency into the financial reporting process. Therefore, when an auditor identifies and communicates to management a significant matter that is not necessarily material to the financial statements, and management does not adequately address that matter in the financial statements, the

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<sup>14/</sup> Rule 2-02 of Regulation S-X, 17 CFR §210.2-02.

<sup>15/</sup> AU sec. 508.19.

<sup>16/</sup> AU sec. 508.11.

auditor does not have a practical alternative. Accordingly, as previously mentioned, while many investors supported retaining the pass/fail opinion, they recommended supplementing it with additional information about the audit and the company's financial statements to enable the auditor to add commentary on significant matters.

Some preparers, auditors, and audit committee members support retaining the current pass/fail model and also support clarification of certain language in the report. Some of these outreach participants also are supportive of including some additional information in the auditor's report about the audit or auditor reporting on MD&A or portions thereof, such as "Critical Accounting Estimates."

### Questions

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.
  - a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?
  - b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?
  - c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?
2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."
  - a. Should the auditor's report retain the pass/fail model? If so, why?
  - b. If not, why not, and what changes are needed?

- c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.
3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.
4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?

### **III. Potential Alternatives for Changes to the Auditor's Report**

Input from the staff's outreach reinforces the view that many investors are supportive of changing the auditor's reporting model. Investor demands for such change are expressed in terms of making the auditor's reporting model, and thus audits, more relevant to investors and other users of financial statements. Though the auditor's reporting model has been studied by many groups that have provided recommendations over time, they were not in a position to effect change as they did not have standard-setting authority. The Board has an opportunity to change the auditor's reporting model under its statutory mandate to protect the interests of investors in the preparation of informative, accurate and independent audit reports. Therefore, the Board is in a position to promote the transparency and continued relevance of the audit and the related auditor's reporting model, in collaboration with the SEC. The Board is soliciting the views of commenters on the concerns that have been expressed about the auditor's reporting model, potential alternatives for change to the auditor's report, the potential direction of a possible standard-setting project, and potential other considerations associated with changes to the auditor's report.

This concept release presents several alternatives and seeks specific comment on these or other alternatives that could provide investors with more transparency into the audit process and more insight into the company's financial statements or other information outside the financial statements. These alternatives are not intended to alter, in any way, the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. Nor are these alternatives intended to

qualify or piecemeal the auditor's opinion or to shift the requirement to assess the risk of material misstatement of the financial statements from the auditor to investors or other users of financial statements.

The alternatives presented in this concept release are:

- Auditor's Discussion and Analysis,
- Required and expanded use of emphasis paragraphs,
- Auditor assurance on other information outside the financial statements, and
- Clarification of language in the standard auditor's report.

These alternatives are not mutually exclusive, nor do these alternatives include all the views expressed by the outreach participants.<sup>17/</sup> A revised auditor's report could include one or a combination of these alternatives, elements within the alternatives, or alternatives not currently presented in this concept release.

All of the alternatives presented would retain the pass/fail opinion of the standard auditor's report. Some of the alternatives presented in the concept release (e.g., Auditor's Discussion and Analysis, required and expanded use of emphasis paragraphs, and clarification of language in the standard auditor's report) are designed to improve communication of the auditor's current responsibilities related to a financial statement audit based on existing auditing standards. The alternative for auditor assurance on other information outside the financial statements would require an expansion of the auditor's current responsibilities, which would likely necessitate the development of a management reporting framework and additional auditing standards through collaboration with the SEC. Most of these alternatives would likely require the development of additional suitable and objective criteria for auditors to prepare consistent and comparable auditors' reports.

#### **A. Auditor's Discussion and Analysis**

A revised auditor's reporting model could include a supplemental narrative report, which some have described as an Auditor's Discussion and Analysis ("AD&A"). An

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<sup>17/</sup> Appendix C provides a detailed discussion of the views of the outreach participants.

AD&A could provide investors and other financial statement users with a view of the audit and the financial statements "through the auditor's eyes."

The intent of an AD&A would be to provide the auditor with the ability to discuss in a narrative format his or her views regarding significant matters. The AD&A could include information about the audit, such as audit risk identified in the audit,<sup>18/</sup> audit procedures and results, and auditor independence. It also could include a discussion of the auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." Additionally, an AD&A could provide the auditor with discretion to comment on those material matters that might be in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their impact on the financial statements. An AD&A could also highlight those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures.

An AD&A, as contemplated herein, is not intended to provide separate assurance on individual balances, disclosures, transactions, or any other matters discussed. Rather, an AD&A is intended to facilitate an understanding of the auditor's opinion on the financial statements taken as a whole.

An AD&A could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors. An AD&A could provide further context to an investor's understanding of a company's financial statements and management's related discussion and analysis, and provide the auditor with the ability to communicate to investors and other users of financial statements the auditor's significant judgments in forming the audit opinion. An

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<sup>18/</sup> 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. Audit risk is a function of the risk of material misstatement and detection risk. Some investors have defined risk more broadly to include not only audit risk, but also business risks, operating risks, or strategic risks. The discussion of risk addressed in this alternative is limited to audit risk that the auditor is required to identify under current auditing standards (see detailed discussion in Appendix C). Discussion of risk other than audit risk would require an expansion of the auditor's current responsibilities. This would be a major undertaking requiring additional education, training, standard-setting, and collaboration with the SEC.



AD&A also could provide the auditor with an adaptable report that he or she can tailor to a company's specific risks, facts, and circumstances.

Because an AD&A provides the auditor's perspectives about the audit and the company's financial statements, the perspectives in the AD&A on certain matters could differ from those that management has provided in the MD&A. As a result, additional time might be incurred by management, the audit committee, and auditors to seek to resolve such differences before any views are reflected in the AD&A or MD&A. If the AD&A and the MD&A expressed different views on certain matters, the financial statement user might need to reconcile these differing views. Further, there is a risk that the language in an AD&A might become boilerplate in nature over time.

An AD&A would likely be among the most expansive form of reporting of the alternatives presented since it would provide auditor commentary on significant matters to the users of financial statements. An AD&A also could require the auditor to communicate some of the same information that the auditor communicates to the audit committee. Many of the matters that could be discussed in an AD&A are part of the audit performed pursuant to current auditing standards. However, the PCAOB, in collaboration with the SEC, would likely need to develop new auditing standards to provide standard, objective criteria to the auditor regarding the appropriate content and level of detail to be reported in an AD&A. For example, reporting on difficult or contentious issues, including "close calls" would require additional direction to auditors in identifying and reporting on such matters.

The Board is seeking comment on an AD&A as a potential supplemental report to the standard auditor's report. The following illustrates a potential framework for an AD&A report, including the types of potential criteria that might assist the auditor in preparing an AD&A. This illustrative report does not include certain matters raised in the staff's outreach, such as materiality levels, engagement statistics, and information communicated to the audit committee, although such matters, as well as other matters, could be included in an AD&A.<sup>19/</sup>

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<sup>19/</sup> See Appendix C for a detailed discussion of the staff's outreach regarding materiality levels, engagement statistics and information communicated to the audit committee.

**Illustration of Possible Revised Standard Auditor's Report and  
Auditor's Discussion and Analysis**

Report of Independent Registered Public Accounting Firm

[Standard Introductory Paragraph]

[Standard Scope Paragraph]

[Standard Opinion Paragraph]

Our audits were conducted for the purpose of forming an opinion on the financial statements, including related disclosures, taken as a whole. The accompanying Auditor's Discussion and Analysis provides additional analysis.

[Signature]

[City and State or Country]

[Date]

**Auditor's Discussion and Analysis**

This discussion should be read in conjunction with the accompanying auditor's report on the financial statements. We considered the matters discussed below in rendering our opinion on the financial statements taken as a whole. This discussion does not represent separate assurance on individual account balances, disclosures, transactions, or any other matters discussed below. It is not a substitute for the user's full reading and review of such financial statements, including related disclosures, and the auditor's report.

[Auditor discussion concerning the audit or the company's financial statements could be included under headings or in sections of an AD&A such as those set out below. Following each heading is the concept for a possible instruction for drafting the discussion. The potential drafting instructions are intended only to illustrate the possible content of each section; if the Board pursues an AD&A approach, complete requirements would be proposed for public comment.]

**Information about the Audit**

**Audit Risk**

[Provide a discussion of significant risks identified by the auditor.<sup>20/</sup> This discussion should include the factors the auditor evaluated in determining which risks are significant (see paragraphs 70-71 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*). Describe why the risks are considered significant to the company's financial statements.]

**Audit Procedures and Results**

[Provide a discussion of the audit procedures responsive to the significant risks discussed in the audit risk section above, why the procedures are responsive to such significant risks, and the results of those procedures (see Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*).]

**Auditor Independence**

[Provide a discussion of matters that were reported and discussed with the audit committee concerning independence under PCAOB Rule 3526, *Communication With Audit Committees Concerning Independence*, and the related resolution of those matters. Provide affirmation of auditor independence.]

**Information about the Company's Financial Statements**

**Management's Judgments and Estimates**

[Provide a discussion of the critical accounting estimates that were communicated to the audit committee and assumptions underlying the critical accounting estimates (see proposed Auditing Standard,

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<sup>20/</sup> Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describes significant risk as a risk of material misstatement that requires special audit consideration.

*Communications with Audit Committees*<sup>21/</sup>). The discussion also should address how the critical accounting estimates are susceptible to change.]

### **Accounting Policies and Practices**

[Provide a discussion of the company's critical accounting policies and practices, including significant unusual transactions that were communicated to the audit committee. This discussion should include the reasons the auditor considers certain policies and practices to be critical, including those that management does not consider critical. Also, provide a discussion of alternative accounting treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor.<sup>22/</sup>]

### **Difficult or Contentious Issues, Including "Close Calls"**

[Provide a discussion of the difficult or contentious issues or "close calls" that arose during the audit and the final resolution of the issue. These issues might include, among other things, the following –

- Those accounting matters that required significant deliberation by the auditor and management before being deemed acceptable within the applicable financial reporting framework.
- Those matters related to internal control over financial reporting that required significant deliberation by the auditor and management.
- A financial statement issue that had a potential material impact to the financial statements and was corrected prior to the end of the period.]

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<sup>21/</sup> See proposed auditing standard related to communications with audit committees at: <http://pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx>.

<sup>22/</sup> See Rule 2-07(a)(1) of Regulation S-X, 17 CFR §210.2-07(a)(1), which requires the auditor to report the critical accounting policies and practices and alternative accounting treatments to the audit committee.

**Material Matters**

[Describe those material matters that are in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their effect on the financial statements, or those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures.]

Questions

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?
  - a. If you support an AD&A as an alternative, provide an explanation as to why.
  - b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?
  - c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?
  - d. If you do not support an AD&A as an alternative, explain why.
  - e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?
6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?
7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates,

accounting policies and practices, and difficult or contentious issues, including "close calls")?

8. Should a standard format be required for an AD&A? Why or why not?
9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?
10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?
11. What are the potential benefits and shortcomings of implementing an AD&A?
12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

## **B. Required and Expanded Use of Emphasis Paragraphs**

Another alternative to enhance the auditor's report could be to require and expand the use of emphasis paragraphs in all audit reports. Emphasis paragraphs are not currently required under existing PCAOB standards but may be added, solely at the auditor's discretion, to emphasize a matter regarding the financial statements.<sup>23/</sup> Examples of emphasis paragraphs given in the current auditing standards include –

- That the entity is a component of a larger business enterprise.
- That the entity has had significant transactions with related parties.
- Unusually important subsequent events.

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<sup>23/</sup> AU sec. 508.19. Additionally, AU sec. 508.11 describes certain circumstances that, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory paragraph to the standard auditor's report.



- Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.<sup>24/</sup>

This alternative would mandate the use of emphasis paragraphs in all audit reports and further expand the emphasis paragraph to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements. Emphasis paragraphs could be required in areas of critical importance to the financial statements, including 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. With respect to each matter of emphasis under this alternative, the auditor also could be required to comment on key audit procedures performed pertaining to the identified matters.

This alternative is somewhat analogous to the French auditor's report. French law requires the auditor's report to contain a "justification of the auditor's assessments."<sup>25/</sup> The auditor is required, in an explanatory paragraph, to explain the procedures the auditor performed with respect to relevant areas of the audit, such as accounting policies, accounting estimates, and overall presentation of the financial statements.

Required emphasis paragraphs could be beneficial to financial statement users through the auditor's identification of significant matters and referencing where those matters are disclosed in the financial statements. An auditor's emphasis of certain aspects of the financial statements in the auditor's report also could potentially increase the quality of management's disclosures in the financial statements because of specific reference to such disclosures in the auditor's report. However, the content might not provide investors with the full extent of detail that some investors indicated that auditors should provide in the auditor's report, and the language in required emphasis paragraphs might become boilerplate in nature over time.<sup>26/</sup>

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<sup>24/</sup> Ibid.

<sup>25/</sup> On August 1, 2003, article L823-9 of the French Code of Commerce Financial security laws required that the statutory auditor include in the auditor's report a "justification of the auditor's assessments."

<sup>26/</sup> The IAASB's Consultation Paper, p.19, stated that the disclosures in the justification of the auditor's assessments paragraphs "may become standardized (or boilerplate) over time in relation to an entity, and the way they are presented in the auditor's report may detract from the readability of the report."

This alternative primarily communicates those matters that the auditor is required to address as part of an audit pursuant to current auditing standards. However, the Board may need to develop additional auditing standards to direct the auditor in determining which matters are of the most importance to emphasize in an auditor's report.

The following illustrates a potential auditor's report with required emphasis paragraphs, including the types of potential criteria that might assist the auditor in preparing the report.

**Illustration of Possible Revised Standard Auditor's Report with  
Required Emphasis Paragraphs**

Report of Independent Registered Public Accounting Firm

[Standard Introductory Paragraph]

[Standard Scope Paragraph]

[Standard Opinion Paragraph]

Required Emphasis Paragraph[s]

[Emphasize those matters that are important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty. Discuss the audit procedures performed on these significant matters. This discussion should not include matters that the company has not disclosed in the financial statements and should make reference to the notes in the financial statements that disclose each matter.]

[Signature]

[City and State or Country]

[Date]

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Questions

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?
14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?
  - a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.
  - b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.
15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?
16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?
17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?
18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

**C. Auditor Assurance on Other Information Outside the Financial Statements**

Another alternative to enhance the auditor's reporting model could be to require auditors to provide assurance on information outside the financial statements, such as MD&A or other information (for example, non-GAAP information or earnings releases). An auditor providing assurance on information outside of the financial statements could improve the quality, completeness, and reliability of such information, providing investors and other users of financial statements with a higher level of confidence in information about the company that is provided by management. Further, many investors and other financial statement users often comment on the importance to their investing decisions of the information outside the financial statements. Their view is that investors use and rely on MD&A and other financial information (e.g., non-GAAP

information and earnings releases) for their investing decisions, in addition to historical audited financial statements. Therefore, this additional reporting could make an audit and auditor reporting more relevant to investors and other users of financial statements.

Providing assurance on information outside the financial statements would increase the scope of the auditor's responsibilities, require the development of new auditing standards, and might result in projects separate from the auditor's reporting model project. Additionally, to provide a basis for auditor assurance on information outside the financial statements, a reporting framework would likely need to be developed for management's presentation of such information in collaboration with the SEC. The SEC maintains disclosure and reporting requirements for MD&A, which may need to be changed, including filing requirements to include the auditor's reporting on MD&A.<sup>27/</sup> Also, if auditors were required to provide assurance on non-GAAP information and non-GAAP information, the SEC would likely need to develop new management reporting requirements.

Currently, there is no requirement for the auditor to provide assurance on earnings releases, non-GAAP information, or MD&A. Although the company has the ability to retain the auditor to provide some level of assurance under PCAOB standards,<sup>28/</sup> the auditor is rarely retained to provide any assurance on such information. Current auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements (e.g., MD&A). These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact.<sup>29/</sup>

The PCAOB has an attest standard which provides requirements for the auditor concerning the performance of an attest engagement with respect to MD&A, if the auditor is engaged to attest on MD&A.<sup>30/</sup> In an attest engagement under PCAOB

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<sup>27/</sup> In the SEC's 2002 proposal regarding critical accounting estimates, the SEC specifically requested comment on auditor involvement in MD&A. *See Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*, Securities Act Release No. 8098 (May 10, 2002).

<sup>28/</sup> *See* AT sec. 201, *Agreed-Upon Procedures Engagements* and AT sec. 701, *Management's Discussion and Analysis*.

<sup>29/</sup> Paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

<sup>30/</sup> AT sec. 701.

standards, the auditor performs procedures to express an opinion on the MD&A presentation taken as a whole by reporting whether the –

- Presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC,
- Historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements, and
- Underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.<sup>31/</sup>

The additional reporting by the auditor on earnings releases, non-GAAP information, the entire MD&A, or portions thereof, could be based on certain aspects of the current attest standard and report, which is illustrated below, or other attest standards. However, the current attest standard and this illustration are not intended to represent the only alternative for reporting on MD&A or portions thereof, earnings releases or non-GAAP information.

**Illustration of Attachment to Possible Revised Standard Auditor's Report – Standard Examination Report on Management's Discussion and Analysis ("MD&A")<sup>32/</sup>**

AT sec. 701, *Management's Discussion and Analysis*, establishes requirements concerning the performance of an attest engagement with respect to MD&A prepared pursuant to the rules and regulations adopted by the Securities and Exchange Commission, which are presented in annual reports to shareholders and in other documents.<sup>33/</sup>

Independent Accountant's Report

[Introductory paragraph]

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole, included [incorporated by reference] in the

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<sup>31/</sup> AT sec. 701.05.

<sup>32/</sup> AT sec. 701.114.

<sup>33/</sup> AT sec. 701.01.

Company's [insert description of registration statement or document]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the presentation based on our examination. We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [Month] XX, 20X6, we expressed an unqualified opinion on those financial statements.

[Scope paragraph]

Our examination of Management's Discussion and Analysis was conducted in accordance with attestation standards established by the Public Company Accounting Oversight Board (United States) and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides a reasonable basis for our opinion.

[Explanatory paragraph]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[Opinion paragraph]

In our opinion, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange



Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[Signature]

[City and State or Country]

[Date]

Questions

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?
- a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.
  - b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.
  - c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?
  - d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?
  - e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?
  - f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?
  - g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

**D. Clarification of the Standard Auditor's Report**

Another potential enhancement of the auditor's reporting model could involve clarifying language in the existing standard auditor's report. While this alternative would not significantly expand the content of the auditor's report, it could provide additional explanation about what an audit represents and the related auditor responsibilities. Possible language that could be clarified in the auditor's report includes –

- *Reasonable Assurance* – The standard auditor's report explicitly asserts that the audit was conducted in accordance with auditing standards and states that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The auditing standards describe reasonable assurance as being a "high level of assurance, but not absolute assurance." Such language could be added to the auditor's report or reasonable assurance could be further explained.
- *Auditor's Responsibility for Fraud* – The standard auditor's report does not mention "fraud" and is silent about the auditor's responsibility to detect fraud. The auditing standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.<sup>34/</sup> Such language could be added to the auditor's report or the auditor's responsibility could be further explained.
- *Auditor's Responsibility for Financial Statement Disclosures* – The auditor's report identifies the balance sheets, related statements of operations, stockholders' equity and cash flows as the financial statements. As it relates to financial statements under Regulation S-X, the SEC's rules provide that "financial statements" include all notes to the financial statements and all related schedules.<sup>35/</sup> The auditing standards require auditors to perform procedures to test the financial statement disclosures

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<sup>34/</sup> AU sec. 230, *Due Professional Care in the Performance of Work*, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>35/</sup> Rule 1-01(b) of Regulation S-X, 17 CFR §210.1-01.

and to evaluate whether the financial statements contain the information essential for fair presentation of the financial statements in conformity with the applicable financial reporting framework.<sup>36/</sup> Auditing standards also require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional;<sup>37/</sup> to identify and test significant disclosures;<sup>38/</sup> and, in integrated audits, to test controls over significant disclosures.<sup>39/</sup> The auditor's report could be revised to provide clarification regarding the auditor's responsibility for financial statement disclosures.

- *Management's Responsibility for the Preparation of the Financial Statements* – The auditor's report includes 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.<sup>40/</sup> The Act requires corporate officers to certify in periodic filings with the SEC that "based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer, as of, and for, the periods presented in the report."<sup>41/</sup> The auditor's report could be further clarified to state that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.
- *Auditor's Responsibility for Information Outside the Financial Statements* – As described in the section above, the auditor has a responsibility to read

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<sup>36/</sup> Paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*.

<sup>37/</sup> See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

<sup>38/</sup> See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements.

<sup>39/</sup> Paragraph 26 of Auditing Standard No. 5.

<sup>40/</sup> AU sec. 508.08c.

<sup>41/</sup> Section 302(a)(3) of the Act.

the other information in documents containing audited financial statements and consider whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact.<sup>42/</sup> Such information might be financial or non-financial information and includes the Chairman's or CEO's letter to shareholders, risk disclosures, MD&A, and the other portions of documents containing audited financial statements. The auditor's report could be clarified to describe the auditor's responsibility with respect to such other information.

- *Auditor Independence* – The title of the standard auditor's report is "Report of Independent Registered Public Accounting Firm." Aside from the title, the auditor provides no further information regarding the auditor's independence or otherwise provides assurance that the auditor has complied with the applicable independence requirements of the PCAOB and SEC. The auditor's report could be clarified to include a statement in the auditor's report, in addition to the title, that the auditor has a responsibility to be independent of the company and has complied with applicable independence requirements of the PCAOB and SEC.

### Questions

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:
  - Reasonable assurance
  - Auditor's responsibility for fraud
  - Auditor's responsibility for financial statement disclosures
  - Management's responsibility for the preparation of the financial statements
  - Auditor's responsibility for information outside the financial statements
  - Auditor independence

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<sup>42/</sup>

AU sec. 550.04 - .06.

- a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?
  - b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.
  - c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?
  - d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?
22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

Questions Related to all Alternatives

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?
24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?
25. What alternatives not mentioned in this concept release should the Board consider?
26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?
28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?
29. What effect would the various alternatives have on audit quality? What is the basis for your view?
30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.

#### **IV. Considerations Related to Changing the Auditor's Report**

During the staff's outreach, various participants suggested that there may be practical challenges and unintended consequences that would result from additional auditor reporting. These challenges and consequences are discussed throughout this concept release and described further below. The Board is interested in comment on these and other issues in connection with its deliberations on potential changes to the auditor's report.

##### **A. Effects on Audit Effort**

Some outreach participants expressed concern regarding the effect of changing the auditor's report on the overall timing and extent of the audit effort. Since many of the alternatives presented in this concept release focus on auditor reporting and do not require additional audit procedures by the auditor in forming the opinion on the financial statements, some expressed a view that the auditor's incremental efforts and cost to report such information should be minimal. However, a movement away from using standardized language in the auditor's report could also require additional audit effort, such as the auditor's time and effort in preparing and reviewing the report, which could result in an increase in cost. If auditors were required to prepare and issue a non-standardized report, each engagement might be required to have a centralized quality



control review of all such reports for appropriateness and consistency among the firm's various audit clients. Additionally, audit firms might need to develop training for individual auditors on how to prepare non-standardized reports, particularly since auditors may not have experience writing narrative reports for public use.

Including additional information in an auditor's report could necessitate extensive discussion and potential debate among management, the auditor, and the audit committee regarding the nature and extent of the information. This discussion, combined with drafting narrative-type auditor's reports and enhanced quality control procedures, could increase the time to complete the audit and issue an opinion, and present challenges in terms of the preparer's ability to meet public reporting deadlines.

Some of the alternatives presented in this concept release also could involve an increase in the scope of the auditor's responsibilities, thereby increasing audit requirements and procedures. For instance, if auditors were required to attest on MD&A, or portions thereof, auditors would need to perform additional work, requiring greater time and cost.

## **B. Effects on the Auditor's Relationships**

Some of the outreach participants expressed a concern that discussing potentially sensitive matters in the auditor's report could impair transparency and openness in discussions among auditors, management, and the audit committee. They are of the view that this, in turn, could create more tension in the overall relationship and could stifle communications. For example, 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. As another example, some indicated that an auditor providing information that conflicts with management-prepared information may result in additional stress on the overall relationships, which could lead to other unintended consequences. Management and the audit committee also might be compelled to change the financial statements, in order to eliminate differences between the company's disclosures and the auditor's discussion in the audit report.

## **C. Effects on Audit Committee Governance**

Some outreach participants expressed concerns that if the auditor were to provide information directly to investors regarding the company's financial statements, then this could undermine the governance role of the audit committee, since the audit committee's role is to provide oversight of the financial reporting process on behalf of investors. Some questioned the audit committee's relevance in the financial reporting

process if auditors were to provide the same information to investors as is provided to audit committees.

#### **D. Liability Considerations**

Some outreach participants expressed concern that changes to the auditor's reporting model could result in increased liability for auditors and issuers. These participants noted that in a new model auditors might provide additional information about the audit or the company's financial statements, make additional public statements, or examine or report on more or different types of information. These outreach participants also were concerned that auditor reporting regarding information about the company's financial statements or about the audit could create confusion about those financial statements or about the meaning of an auditor's unqualified opinion, resulting in negative market reaction that could, in turn, lead to litigation against the issuer or auditor.

Liability may be imposed on auditors, issuers, and other securities market participants under a number of different legal theories, depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, as well as various state law causes of action. This concept release is intended to generate a broad-based discussion of ways to make the audit report more relevant to investors. At this stage of the process, the Board is interested in views on how it might do so and has reached no conclusions about whether to propose any particular approach.

#### **E. Confidentiality**

Some outreach participants encouraged the Board, in considering changes to the auditor's report, to consider maintaining the confidentiality of company information if the auditor is required to discuss additional information about the audit or the preparation of the company's financial statements. They stated that there is a possibility that management and others may be concerned about auditors discussing information about the company in the auditor's report that might be deemed proprietary or highly sensitive to the company's competitive industry position.

#### Questions

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

- a. Are any of these considerations more important than others? If so, which ones and why?
  - b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?
  - c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?
  - d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?
32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

**V. Opportunity for Public Comment**

The Board is interested in the views of commenters on the potential direction of a proposed standard-setting project and whether the Board should consider any other approaches. While this concept release includes a number of specific questions for which the Board would like to obtain feedback, the Board welcomes all comments related to enhancing the auditor's reporting model.

The Board will seek comment on this concept release for a 101-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 34 in the subject or reference line and should be received by the Board no later than 5:00 PM EDT on September 30, 2011.

On the 21st day of June, in the year 2011, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Secretary

June 21, 2011

## CONCEPT RELEASE

### Appendix A – History

There has been a longstanding discussion and debate among users of financial statements regarding the form and content of the auditor's report dating back to the early 1900s, when there was an initial attempt to define accounting and auditing practices in the United States.<sup>1/</sup> In the early 1900s, no authoritative accounting or auditing standards existed, and auditors wrote narrative audit reports (free-form) for every company.<sup>2/</sup> These narrative audit reports often described the audit procedures performed during the audit.<sup>3/</sup> By the early 1920s, the narrative auditor's report was reduced to one paragraph in length and was referred to as an audit of the "accounts and records" whereby the independent auditor would "certify" the "balance sheet" as being "correct."<sup>4/</sup>

By the early 1930s "the term 'certify' began to disappear from reports in an attempt to clarify that the auditor's report was an opinion and not a guarantee."<sup>5/</sup> The auditor's report of 1934 was "the first report to have *required* as opposed to *suggested* report wording."<sup>6/</sup> A Securities and Exchange Commission ("SEC") investigation of

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<sup>1/</sup> A discussion of significant historical developments in the evolution of the U.S. Standard Auditor's Report is available on the PCAOB Web site as part of the April 2010 Standing Advisory Group ("SAG") briefing paper at: [http://pcaobus.org/News/Events/Pages/04072010\\_SAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx).

<sup>2/</sup> Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts To Influence the Auditing Standards Board*, 1 (Greenwich, CT:JAI Press Inc., 1993), p. 38.

<sup>3/</sup> Ibid., pp. 5-6.

<sup>4/</sup> Vincent M. O'Reilly, et al., *Montgomery's Auditing*, 11<sup>th</sup>ed. (New York: John Wiley & Sons Inc., 1990), p. 636.

<sup>5/</sup> Geiger, *The New Auditor's Report*, p. 15.

<sup>6/</sup> Ibid., p. 17. According to a special committee of the American Institute of Accountants ("AIA," now known as the American Institute of Certified Public Accountants ("AICPA")), the accounting profession adopted a standard audit report to accomplish two objectives: (1) to institute uniform report language across firms, thus making reports more readily comparable and consequently reducing deficient report quality and misunderstandings due to ambiguous or vague wordings and (2) to make

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McKesson & Robbins resulted in the 1941 issuance of *Accounting Series Release No. 21*.<sup>7/</sup> This release amended Regulation S-X to require changes in the auditor's report to "state whether the audit was made in accordance with generally accepted auditing standards [("GAAS")] applicable in the circumstances."<sup>8/</sup> The AIA formally adopted the GAAS standards in 1948, which resulted in several revisions to the auditor's report.<sup>9/</sup>

In 1979, based on recommendations from the Commission on Auditor's Responsibilities ("Cohen Commission"),<sup>10/</sup> the AICPA's Auditing Standards Board ("ASB") analyzed the standard auditor's report and concluded that "a substantial departure from the existing report, as suggested by [the Cohen Commission] was not needed."<sup>11/</sup> The Cohen Commission had specifically recommended expanding the

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qualifications in audit reports more easily recognizable. See D.R. Carmichael and A.J. Winters, "The evolution of audit reporting," *Proceedings of the 1982 Touche Ross/University of Kansas Symposium on Auditing Problems* (Lawrence, KS: University of Kansas, 1982), p. 6.

<sup>7/</sup> For a summary of the findings and conclusions in the SEC's investigation, see *In the Matter of McKesson & Robbins, Inc.*, Accounting Series Release No. 19, Exchange Act Release No. 2707 (December 5, 1940).

<sup>8/</sup> Accounting Series Release No. 21; Securities Act Release No. 2460 (Feb. 5, 1941).

<sup>9/</sup> D.R. Carmichael and A.J. Winters, "The evolution of audit reporting," pp. 20-21. For example, "[r]eference to review of internal control, lack of 'making a detailed audit of transactions,' and 'other supporting evidence' were all deleted in the new report."

<sup>10/</sup> In response to congressional and public scrutiny of the accounting profession, the American Institute of Certified Public Accountants ("AICPA") established the Commission on Auditors' Responsibilities (known for its chairman as the "Cohen Commission") to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors." The Cohen Commission was directed to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish." AICPA, *Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (New York: 1978), p. xi.

<sup>11/</sup> Geiger, *The New Auditor's Report*.

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auditor's report to include a discussion about four distinct areas: (1) financial statements, (2) other financial information (unaudited), (3) internal control, and (4) other matters (such as the company's policy statement on employee conduct and meetings with the audit committee). The Cohen Commission also recommended the auditor describe those areas using a series of standardized alternative phrases or paragraphs.

As a result of congressional hearings leading up to, and recommendations from, the National Commission on Fraudulent Financial Reporting ("Treadway Commission"), a new paragraph, now commonly referred to as the "scope paragraph" was added to the auditor's report in the 1980s.<sup>12/</sup> The scope paragraph states the respective responsibilities of management and the independent auditor, describes the work performed by the auditor, and indicates that sufficient evidence is gathered to provide a reasonable basis for the auditor's opinion. There have been no substantial changes to the required wording of the standard auditor's report since the addition of the scope paragraph. In April 2003, the PCAOB adopted AU sec. 508, *Reports on Audited Financial Statements*, as part of its interim auditing standards.<sup>13/</sup> Subsequently, the PCAOB also adopted Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, which requires that auditors refer in the auditor's report to "the standards of the Public Company Accounting

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<sup>12/</sup> The Treadway Commission was established in response to the congressional and public scrutiny of the accounting profession after significant business failures such as Drysdale Government Securities, Washington Public Power Supply System, Baldwin-United Corp, and E.S.M. Government Securities [SEC, "The Treadway Commission Report: Two Years Later," News Release (January 26, 1989)]. From October 1985 to September 1987, the Treadway Commission studied the financial reporting system in the United States. The Treadway Commission's mission "was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." *Report of the National Commission on Fraudulent Financial Reporting* (October 1987), p. 1 ("Treadway Commission Report").

<sup>13/</sup> References to the PCAOB's interim auditing standards consist of generally accepted auditing standards, as described in the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's Web site at [www.pcaobus.org](http://www.pcaobus.org).



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Oversight Board (United States)"<sup>14/</sup> and adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that establishes requirements for auditors to report on internal control over financial reporting.

In February 2005, the SAG discussed the standard auditor's report, including the advantages and disadvantages of the auditor's reporting model and whether there was a need for a form of auditor reporting other than the pass/fail model.<sup>15/</sup> Several SAG members expressed support for maintaining the pass/fail element of the standard auditor's report, stating that it is "clear," "simple," "consistent," "comparable," and "easy for the investing public to digest."<sup>16/</sup> They also expressed a need for more information and less boilerplate language in the auditor's report.<sup>17/</sup>

In 2008, the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") issued a report ("ACAP Final Report") urging the Board "to undertake a standard-setting initiative to consider improvements in the auditor's standard reporting model and to clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards."<sup>18/</sup> The ACAP Final Report also noted that the "increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting."<sup>19/</sup> In addition, the

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<sup>14/</sup> See Appendix B for an illustrative example of an auditor's standard report on an audit of financial statements according to PCAOB standards.

<sup>15/</sup> See February 16, 2005 SAG briefing paper at: [http://pcaobus.org/News/Events/Documents/02162005\\_SAGMeeting/Auditors%20Reporting%20Model.pdf](http://pcaobus.org/News/Events/Documents/02162005_SAGMeeting/Auditors%20Reporting%20Model.pdf).

<sup>16/</sup> See February 16, 2005 SAG Webcast at: [http://pcaobus.org/News/Webcasts/Pages/02162005\\_SAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/02162005_SAGMeeting.aspx).

<sup>17/</sup> Ibid.

<sup>18/</sup> U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008), available at: <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>, p. VII:13.

<sup>19/</sup> Ibid, p. VII:17.

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ACAP Final Report suggested that this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a "relevant discussion about the audit of the financial statements."<sup>20/</sup>

The ACAP Final Report further recommended that the PCAOB consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal, and foreign regulators.<sup>21/</sup> Consistent with the ACAP's recommendation, the Board held follow-up discussions with the SAG regarding the auditor's reporting model in April and July 2010.<sup>22/</sup> While there was no consensus on what additional information should be included in the auditor's report, there was general support for improvements to the standard auditor's report.<sup>23/</sup> Similar views were expressed during the PCAOB's Investor Advisory Group ("IAG") meetings in May 2010<sup>24/</sup> and March 2011.<sup>25/</sup> Several SAG members also suggested that the PCAOB perform additional outreach to gain further input from investors and others.

From October 2010 through March 2011, the staff of the Office of the Chief Auditor (the "staff") conducted outreach to investors, auditors, preparers, audit committee members, representatives of academia, and others to further explore

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<sup>20/</sup> Ibid.

<sup>21/</sup> Ibid, p. VII:18.

<sup>22/</sup> April and July 2010 SAG meetings. Webcasts available at: [http://pcaobus.org/News/Events/Pages/04072010\\_SAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx) and [http://pcaobus.org/News/Events/Pages/07152010\\_SAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/07152010_SAGMeeting.aspx), respectively.

<sup>23/</sup> Ibid.

<sup>24/</sup> In May 2010, the IAG provided views related to providing greater transparency of the audit process, including making changes to the auditor's report. Available at: [http://pcaobus.org/News/Events/Pages/05042010\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/05042010_IAGMeeting.aspx).

<sup>25/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

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potential improvements to the auditor's reporting model.<sup>26/</sup> The staff reported its findings to the Board at an open meeting on March 22, 2011.<sup>27/</sup>

Separately, a working group of the IAG held a discussion regarding the auditor's reporting model in March 2011.<sup>28/</sup> The discussion included the results of a survey the working group conducted to solicit views regarding changes to the auditor's report. The group surveyed investors in investment banks, mutual funds, pension funds, and hedge funds representing over \$8 trillion under management. Also, in March 2011, the SAG discussed the results of the staff's outreach regarding the auditor's reporting model.<sup>29/</sup>

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<sup>26/</sup> See Appendix C for a detailed discussion on the staff's outreach.

<sup>27/</sup> PCAOB Board Meeting. March 22, 2011, available at: [http://pcaobus.org/News/Events/Pages/03222011\\_OpenBoardMeeting.aspx](http://pcaobus.org/News/Events/Pages/03222011_OpenBoardMeeting.aspx).

<sup>28/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

<sup>29/</sup> SAG meeting, March 24, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03232011\\_SAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03232011_SAGMeeting.aspx).

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### **Appendix B – Overview of Current Reporting Requirements in PCAOB Standards**<sup>1/</sup>

The primary PCAOB auditing standard that applies to audit reports issued in connection with audits of financial statements is AU sec. 508, *Reports on Audited Financial Statements*. AU sec. 508 requires that the standard auditor's report identify the financial statements audited in the introductory paragraph, describe the nature of an audit in the scope paragraph, and include the auditor's opinion in the opinion paragraph.

AU sec. 508 also describes the following types of opinions that the auditor may issue in connection with an audit of the financial statements:

- *Unqualified opinion.* An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles ("GAAP"). Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.
- *Qualified opinion.* A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP.
- *Adverse opinion.* An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with GAAP.

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<sup>1/</sup> Excerpted from AU sec. 508 and Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*. Paragraphs 85-88 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, provide additional elements to be included in the auditor's report and related report examples for situations in which the auditor is engaged to perform an audit of the effectiveness of internal control over financial reporting that is integrated with an audit of financial statements.

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- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.<sup>2/</sup>

Although AU sec. 508 provides for different types of audit reports, the Securities and Exchange Commission ("SEC") does not accept qualified, adverse, or disclaimer opinions.<sup>3/</sup>

In certain circumstances, AU sec. 508 and Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, permit or require the auditor to add an explanatory paragraph to the standard auditor's report.<sup>4/</sup> Circumstances in which the auditor may be required to use an explanatory paragraph include, among other things, situations in which the auditor believes there is substantial doubt about the company's ability to continue as a going concern, there has been a material change between periods in accounting principles or in the method of their application, and there has been a correction of a material misstatement in previously issued financial statements.<sup>5/</sup> Standard auditors' reports with explanatory paragraphs are accepted by the SEC.

AU sec. 508 also permits the auditor to use an emphasis paragraph.<sup>6/</sup> An emphasis paragraph is never required; however, a paragraph may be added solely at the auditor's discretion.<sup>7/</sup> AU sec. 508 provides examples regarding the potential use of an emphasis paragraph, such as situations in which the entity had significant transactions with related parties, there were unusually important subsequent events, and there were specific accounting matters affecting the comparability of the financial statements.<sup>8/</sup>

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<sup>2/</sup> AU sec. 508.10.

<sup>3/</sup> See Accounting Series Release No. 90 (1962); see also Codification of Staff Accounting Bulletins, Topic I.E.2.

<sup>4/</sup> See AU sec. 508.11 and paragraphs 7-8 of Auditing Standard No. 6.

<sup>5/</sup> Ibid.

<sup>6/</sup> AU sec. 508.19.

<sup>7/</sup> Ibid.

<sup>8/</sup> Ibid.

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The following is an illustrative report of an unqualified opinion on an audit of financial statements:<sup>9/</sup>

### Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[Signature]  
[City and State or Country]  
[Date]

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<sup>9/</sup> Excerpted from Auditing Standard No. 1. Paragraph 87 of Auditing Standard No. 5 provides an example of a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting.)

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### **Appendix C – Overview and Results of the Staff's Outreach Activities**

The staff of the Office of the Chief Auditor (the "staff") conducted a series of discussions with various investors and other users of the auditor's report from October 2010 to March 2011. The objective of the discussions was to assess whether changes to the auditor's reporting model may be necessary and, if so, to identify the changes or additional information that investors recommend including in the auditor's report. Conducting outreach was particularly important to the staff's efforts in formulating the potential alternatives presented.

Some investors who participated in the outreach included individuals representing money managers, asset management funds, pension funds, and wealth management funds, and organizations that represent institutional investors; investor advocates; buy- and sell-side analysts from some of the largest investment firms; and analysts from the largest credit rating agencies. The funds, institutions, and companies represented by investors in the staff's outreach represented trillions of dollars of assets under management.

After meeting with investors, the staff extended the outreach to others, including preparers, audit committee members, auditors, and representatives from academia. Participants in the preparer discussions included representatives from several Fortune 50 companies, Fortune 250 companies, Fortune 500 companies, and some smaller public companies. Participants in the audit committee discussions included audit committee members of companies ranging from small non-accelerated filers to Fortune 50 companies. The staff then conducted several discussions with auditors representing leaders from large and small accounting firms who audit both accelerated and non-accelerated filers. The staff also obtained the perspectives of individuals who previously held leadership roles in the accounting profession, at regulatory organizations, or standard setters. Some of these individuals contributed to discussions and commissions that made recommendations regarding improving the auditor's report, such as the American Assembly, the Commission on Auditors' Responsibilities (the "Cohen Commission"), the National Commission on Fraudulent Financial Reporting, the Panel on Audit Effectiveness, and U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP").

Additionally, the staff read and reviewed publicly available information related to the auditor's reporting model from U.S. and international sources, including academic research, surveys, and other publications, to compile a list of matters that investors requested the auditor to include in the auditor's report. The staff has considered this



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information during the staff's outreach to investors and others, and recognizes that broad investor participation in the U.S. securities markets may differentiate the U.S. markets from the capital markets in some other countries.

During the staff's outreach, many investors suggested that the auditor's reporting model should provide greater transparency into the audit process and the auditor's views regarding the company's financial statements. These investors believe that the audit process is robust, but that the standard auditor's report does not adequately communicate the results of such an extensive audit process.<sup>1/</sup>

### A. Value of an Audit and Information to Investors

Many investors generally indicated that the audit is valuable and that auditors have unique and relevant insight into the company, and therefore should provide more information in the auditor's report to make the report more relevant and useful. The staff's outreach to investors indicated that the increase in the complexity and global nature of business and the recent financial crisis have contributed to the demands by some investors for more transparency into the audit process and the company's financial statements. Therefore, during the staff's outreach many investors supported retaining the pass/fail model of the auditor's report due to its clarity, consistency, and comparability. However, many investors also supported supplementing the pass/fail model with additional auditor reporting.

According to the March 2011 investor survey of a working group of the Board's Investor Advisory Group ("IAG"), some investors indicated that transparency can lead to less uncertainty and therefore, potentially more investor confidence in, and more efficient functioning of, the capital markets. Consistent with the staff's outreach, investor respondents to the March 2011 IAG survey agreed that additional information in the auditor's report would enhance the investment process and allow investors to better analyze financial information.<sup>2/</sup>

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<sup>1/</sup> As the Cohen Commission noted, "for the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor's standard report compresses that considerable expenditure of skilled effort into relatively few words and paragraphs."

<sup>2/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

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During the staff's outreach, some investors also indicated that additional information from auditors could help investors in their investment analysis process to more accurately –

- Assign and attribute risks to the quality of the financial reporting of the underlying company, the company's projections, and disclosures.
- Develop investment valuation models, including assigning a value to a company and projecting future results of the company. This development process would include selecting a range of discount rates to apply to a company's earnings to derive a current market value and determine whether a stock is potentially under or overvalued in the market.

Additionally, some investors suggested that additional information in the auditor's report could –

- Identify the areas that might warrant more consideration in making investment decisions,
- Serve as a roadmap to other areas of focus in the financial statements,
- Provide early warning signals to investors regarding potential issues with the company,
- Assist in comparison of companies across an industry, and
- Inform corporate governance decisions regarding auditor and board member retention.

### **B. Information Related to the Audit**

During the staff's outreach, the staff heard from some investors that an auditor's discussion in the auditor's report about the audit and how the audit was conducted could provide financial statement users with a better perspective regarding audit risk.<sup>3/</sup> In

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<sup>3/</sup> 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

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other words, the auditor has relevant insight into the key risks of material misstatement of the company's financial statements, and knowledge of these risks would be useful to investors.

As part of its outreach, the staff explored the information that might be included in the auditor's report regarding how an audit is conducted.

### 1. *Risks*

Some investors indicated that the audit report should discuss information about risks in the following areas and the related auditor responses to those risks –

- Financial statement areas with an increased level of risk of material misstatement based on the nature of the company, industry, and economic conditions;
- Risks related to management's judgments and estimates and management's application of critical accounting policies and practices and estimates;
- Areas in which the auditor exercises an increased level of judgment and/or spends a significant amount of time, including matters about which the auditor had significant consultation outside the engagement team;
- Risks the auditor communicated to the audit committee;
- Risks regarding the company's financial viability, including the company's ability to continue as a going concern for a reasonable period of time; and
- Business, operational, governance, and enterprise risks.

Many outreach participants noted that this discussion of risks may not align with management's discussion and analysis of business risks in Management's Discussion

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materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.

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and Analysis ("MD&A") and therefore not provide a consistent communication to users of financial statements.

Auditing standards require the auditor to identify and assess the risk of material misstatement, including determining significant risks. The auditing standards also provide factors that assist the auditor in considering which risks represent significant risks, such as –

- The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.<sup>4/</sup>

As part of determining which risks are significant risks, the auditor is required to obtain an understanding of the company and its environment, which includes the company's objectives, strategies, and related business risks, to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement of the financial statements.<sup>5/</sup>

In other words, business risks could affect the risk of material misstatement at the financial statement level. For example, a company's loss of financing or declining conditions in a company's industry could affect its abilities to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to items such as the classification of long-term liabilities or the valuation of long-term assets, or it could result in substantial doubt about a company's ability to continue as a going concern. Auditing standards require the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. The requirement for the auditor to obtain an understanding of

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<sup>4/</sup> See paragraph 71 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, for a more detailed list of factors relevant to identifying significant risks.

<sup>5/</sup> See paragraphs 7-14 of Auditing Standard No. 12 for the auditor's responsibilities related to understanding business risks.

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the company and its environment, including related business risk, is intended to focus the auditor on the degree of the "knowledge of the company" that is necessary for a risk-based audit and to explain how knowledge of the company informs the auditor's identification and assessment of audit risk.

As noted above, while some investors have defined risk more broadly, e.g., business risks, operating risks, or strategic risks, the auditor's responsibilities are limited to considering the company's risks only as they relate to informing their assessment of the risk of material misstatement of the financial statements. For example, an auditor is not required to evaluate whether a new product would be successful or not; rather, the auditor is required to consider how an unsuccessful product might affect the risk of material misstatement of inventory and other related assets. The discussion of risk addressed in this concept release is limited to audit risks that the auditor is required to identify under current auditing standards. The risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.<sup>6/</sup>

In the March 2011 IAG investor survey, "77% of the respondents indicated that the auditor should disclose areas with greatest financial statement and audit risk and the audit work performed in those areas."<sup>7/</sup>

### 2. *Audit Procedures and Results*

Some outreach participants suggested that the auditor could summarize the procedures that the auditor performed related to audit risks and management's judgments and estimates, including testing of management's key assumptions that form the basis for these estimates. These outreach participants suggested that the auditor's report should include more information about the procedures the auditor performed related to the detection of fraud.

Some outreach participants suggested that providing a more robust discussion of audit procedures (i.e., procedures in a financial statement audit or procedures in an audit of internal control) would better inform investors as to what an audit represents relative to a particular company or industry. Others suggested that they could use this

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<sup>6/</sup> See footnote 1 to paragraph 1 of Auditing Standard No. 8.

<sup>7/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

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information to separately evaluate whether the auditor has adequately identified and responded to the risks of material misstatement.

Some outreach participants also indicated that they are interested in obtaining more information about the results of the audit, including the auditor's findings. Some outreach participants described such audit results or findings to include –

- The results of audit procedures performed on audit risk areas or areas requiring significant auditor judgment,
- Information on misstatements the auditor communicated to the audit committee, either corrected or uncorrected,
- Significant control deficiencies communicated to the audit committee and the audit procedures performed by the auditors to satisfy themselves that the risk of material misstatement to the financial statements has been appropriately mitigated,
- Areas in which there were difficulties encountered in performing the related audit procedures,
- The auditor's findings with respect to fraud as communicated to the audit committee, and
- Qualitative aspects of the company's accounting practices, financial statements, and disclosures discussed with the audit committee.

Some outreach participants suggested that the auditor provide more discussion about the nature of the results and findings from the audit or the resolution of issues that arose during the audit.

Other outreach participants expressed concern that providing a list of the audit procedures performed might not provide investors with information that would be useful in making an investment decision. These outreach participants also pointed out that the reference to PCAOB auditing standards in the scope paragraph signifies that the auditor has applied a comprehensive set of required audit procedures. Some outreach participants expressed concern that without the proper two-way dialogue regarding audit results, information about audit results might be taken out of context. Certain outreach participants indicated that the issuance of an unqualified opinion signifies the

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final results of an audit (i.e., the financial statements present fairly, in all material respects, in accordance with the applicable financial reporting framework) and that all material issues identified during the audit have been resolved.

### 3. *Materiality Levels*

During the staff's outreach, some outreach participants expressed an interest in knowing the auditor's quantitative and qualitative materiality levels and the factors the auditor considered in establishing the materiality levels. These outreach participants acknowledged that the auditor makes an assessment of materiality based on the needs of a reasonable investor.<sup>8/</sup> In that regard, some outreach participants suggested the auditor's report should describe the quantitative materiality level established in the audit as well as the basis the auditor used in establishing that materiality level (e.g., net income or percentage of net income). Some outreach participants indicated that the auditor also should discuss the qualitative factors the auditor used in evaluating the materiality of misstatements.

Some outreach participants indicated that trying to select one number to be discussed in the auditor's report could be especially difficult because there are many measurements and assessments of materiality throughout an audit. For example, some outreach participants indicated that the auditor should discuss in the auditor's report materiality considered in planning the audit, while other outreach participants indicated the auditor should discuss in the auditor's report the actual, final materiality level used to evaluate the financial presentation as a whole. Further, others expressed concern that providing materiality levels (qualitative or quantitative) in the auditor's report might result in an inconsistent communication due to a lack of comparability among companies. For example, depending on the company, its industry, and its financial results in a given year, materiality levels might be based on different criteria, such as net income, revenue, or stockholders' equity. Some outreach participants suggested that disclosing materiality levels in the auditor's report could have negative implications on audit quality. For example, they noted that discussing materiality levels in an auditor's report could reduce the element of surprise necessary in an audit.

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<sup>8/</sup> See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.



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According to the March 2011 IAG investor survey, "56% of respondents believe the auditor should disclose quantitative and qualitative materiality thresholds and considerations, while 17% of respondents disagree with requiring such disclosure."<sup>9/</sup>

### 4. *Auditor Independence*

Some outreach participants suggested that the auditor should discuss in the auditor's report information regarding the auditor's independence. According to the March 2010 CFA survey, "72% of respondents would like to see information on circumstances or relationships that might bear on the auditor's independence."<sup>10/</sup> The staff's outreach participants indicated that the type of auditor independence matters that could be included in the auditor's report are –

- The nature and extent of non-audit services the auditor provided to the company,
- Information regarding the auditor's independence as provided to the audit committee,
- Information describing the process the auditor used to assess the auditor's independence, and
- Information describing any mutuality of interests or conflicts of interest between the auditor and the company.

Some outreach participants indicated that they could benefit from such information in order to assess the auditor's relationship and independence with respect to the company. Some outreach participants further indicated that an understanding of auditor independence might help inform their voting decisions on the election, approval or ratification of the auditor in the proxy.

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<sup>9/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

<sup>10/</sup> CFA Institute, *Independent Auditor's Report Survey Results*, (March 2010), available at: [www.cfainstitute.org/Survey/independent\\_auditors\\_report\\_survey\\_results.pdf](http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf).

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Other outreach participants indicated that audit committees play a critical role in monitoring auditor independence, for example, pre-approving audit and non-audit services. Some outreach participants indicated that the title of the standard auditor's report (i.e., "Report of Independent Registered Public Accounting Firm") conveys compliance with the independence rules and suggested that additional discussion regarding independence could be redundant, and possibly ineffective without the benefit of the dialogue between the auditor and the audit committee about matters affecting the auditor's independence.

### 5. *Engagement Statistics*

Some outreach participants indicated that an understanding of key engagement statistics would provide useful information in assessing the quality of the audit. The key engagement statistics have been described as follows –

- Information regarding the composition, tenure, and quality of experience of the audit engagement team (particularly the engagement partner and senior manager);
- The number of hours and fees spent on the engagement in aggregate or spent in significant audit risk areas;
- The percentage of the aggregate audit hours spent, or the percentage of the aggregate hours spent by the engagement partner and managers, on significant audit risk areas; and
- The number of hours and changes in hours year-over-year and significant reasons for such changes.

Some outreach participants suggested that information regarding the composition of the engagement team could provide a sense of the level of expertise and the engagement team's institutional knowledge regarding the company. They further indicated that information regarding the number of hours spent by significant audit risk area could be useful in assessing the auditor's effort. Finally, some outreach participants indicated that a more thorough understanding of the hours and fees could be relevant in considering whether the auditor inappropriately reduced its audit scope due to fee pressures. For example, they noted that, in a recessionary economic environment, the risk of material misstatement and fraud risk could increase;

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consequently, some expressed an interest in knowing whether auditors spent more time in certain audit risk areas.

Others expressed a view that the level of hours on a particular engagement or audit area within an audit is not necessarily an indicator of audit quality. For example, an audit of a company with primarily manual controls or a decentralized accounting system typically would require more audit hours than an audit of a similar company with primarily automated controls or a centralized accounting system. Further, some outreach participants suggested that the number of audit hours does not necessarily address the quality of a company's audit.

### **C. Information Related to the Company's Financial Statements**

Although the current auditor's report provides the auditor's opinion on whether the financial statements are fairly presented in conformity with the applicable financial reporting framework, some outreach participants indicated that not all financial statements that are "presented fairly" may be considered equivalents, or of equal quality. In other words, accounting frameworks provide for various management judgments and estimates in the company's application of accounting policies and practices. The increased levels of judgments and estimates are susceptible to management bias and could result in a wide range of acceptability within the company's applicable financial reporting framework. This range of acceptability is not reflected in the auditor's opinion.

Many preparers, audit committee members, and auditors are not supportive of adding company-specific information to the auditor's report. They noted that management should be the primary source of the company's financial information or such information should come from the audit committee, which is responsible for the oversight of the financial reporting process.

#### **1. *Management's Judgments and Estimates***

Many outreach participants indicated that it would be useful if the auditor were to provide relevant information, including the auditor's views, on management's assumptions, methodologies, and accounting policies related to accounting estimates that involve a high degree of complexity or judgment. They indicated that financial statements include many estimates that are based on management's judgments regarding assumptions, methodologies, and accounting policies. For example, items in the financial statements involve fair value accounting for which there may be a relatively wide range of potential estimation, and some outreach participants would like to know

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information about the ranges as well as the auditor's views on the appropriateness of the estimate recorded within the range. Some outreach participants further recognize that management's judgments and estimates inherently include management bias. Therefore, more information regarding the reasonableness and consistency of, changes in, and ranges of possible outcomes and management's selection within those ranges could be useful to the users of financial statements. This additional information might include the reasonableness and consistency of, and changes in, assumptions, inputs, methodologies and accounting policies.

This request is consistent with the March 2011 IAG investor survey that indicated that "79% of respondents believe the auditor should discuss significant estimates and judgments made by management, the auditor's assessment of their accuracy, and how the auditor arrived at that assessment (14% disagree with requiring this disclosure)."<sup>11/</sup>

With regard to management's estimation process, some outreach participants said that they would benefit from knowing more about the process that management used to determine an estimate, the key assumptions used, and other factors that management considered in developing an estimate. Because estimates by their nature are not exact, the auditor's description of the process that management used to determine the estimates, as well as other factors management considered, would better inform the investor in evaluating the overall presentation of the financial statements.

Some outreach participants suggested that the auditor's discussion could focus on the most critical accounting estimates with assumptions that have a potential material impact on the financial statement results. They also suggested that the auditor's discussion could focus on the ranges used in the estimates. This discussion could be aligned with management's discussion of critical accounting estimates in the MD&A.

Other outreach participants indicated that it is management's responsibility to discuss the company's financial information, including the judgments and estimates that embody the financial statements. Some outreach participants are concerned that information provided by the auditor regarding his or her views about management's judgments might differ from the disclosures management makes in the MD&A, which includes management's views about the financial statements. These sources of information might suggest inconsistencies to the investor. Therefore, if auditors are

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<sup>11/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

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required to provide their views in the auditor's report about management's judgments and estimates, then management might be compelled to make changes to its judgments and estimates solely based on the auditor's views (i.e., management might be influenced to use judgments or estimates suggested by the auditor). Some outreach participants further indicated that if the auditor were to provide information about the company's financial statements, then this could cause preparers to default to "auditor preference" for judgments and estimates. In other words, it may not always be appropriate for the auditor to provide this information, because management, not the auditor, is in the best position to make assumptions and judgments about its business.

### 2. *Accounting Policies and Practices*

Some outreach participants recommended that the auditor provide his or her views regarding the appropriateness of the company's application and consistency of the company's critical accounting policies and practices. They suggested that this discussion should align with the critical accounting policies and practices that management disclosed in its MD&A. The Securities and Exchange Commission ("SEC") describes critical accounting policies and practices as a company's accounting policies and practices that are most important to the presentation of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.<sup>12/</sup> Other outreach participants suggested that the auditor discuss which accounting policies management used that are considered acceptable, but not preferable, under the applicable financial reporting framework.<sup>13/</sup>

According to the March 2011 IAG investor survey, "65% of respondents believe the auditor should discuss quality, not just acceptability, of the accounting policies and practices employed as well as the consistency of their application, while 15% disagree with requiring this disclosure."<sup>14/</sup>

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<sup>12/</sup> See *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, Securities Act Release No. 8040 (December 12, 2001).

<sup>13/</sup> The SEC currently requires a "preferability letter" from the auditor when a company changes accounting principles or practices. See Item 601(b)(18) of Regulation S-K, 17 CFR § 229.601(b)(18); Rule 10-01(b)(6) of Regulation S-X, 17 CFR § 210.10-01(b)(6).

<sup>14/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

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Additionally, some outreach participants suggested that the auditor should discuss alternative accounting policies that the auditor discussed with management or policies that are different from other companies in the company's industry. Some outreach participants said that when there are alternative accounting treatments, the auditor should describe the alternative accounting treatment available under the applicable financial reporting framework and could indicate the treatment that the auditor preferred.<sup>15/</sup>

Some outreach participants indicated that when an auditor has agreed that a company's policy is acceptable, then providing additional information on alternative policies may be misleading. This is due to the fact that the full context of the reasons behind the company's accounting policy decisions, and reasons for their acceptability based on the company's facts and circumstances, are not provided. Further, some cautioned that the auditor should not indicate a preference for or against the company's particular policies and providing this information in the auditor's report could result in management adopting policies or practices that reflect the auditor's view rather than management's view.

Some outreach participants indicated that the auditor also should discuss in the auditor's report significant unusual transactions to enhance investors' understanding of how those transactions impact the financial statements. According to the March 2011 IAG investor survey, "67% of respondents believe the auditor should disclose unusual transactions while 14% disagree with requiring this disclosure."<sup>16/</sup>

### 3. *Difficult or Contentious Issues, Including "Close Calls"*

Some outreach participants recommended that the auditor identify in the auditor's report the most difficult or contentious issues discussed with management. Difficult or contentious issues might arise in various stages of the audit, including in the auditor's evaluation of management's judgments, estimates, and accounting policies. Many

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<sup>15/</sup> The SEC currently requires a "preferability letter" from the auditor when a company changes accounting principles or practices. See Item 601(b)(18) of Regulation S-K, 17 CFR § 229.601(b)(18); Rule 10-01(b)(6) of Regulation S-X, 17 CFR § 210.10-01(b)(6).

<sup>16/</sup> IAG meeting, March 16, 2011. Event details and webcast available at: [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).



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outreach participants described difficult or contentious issues as those critical matters that concerned the auditor when making the auditor's final assessment of whether the financial statements are presented fairly. A difficult issue might not always be synonymous with a contentious issue. Rather, a difficult issue might be a matter that requires significant consideration or consultation; however, the auditor might agree with management's conclusions regarding the issue. A contentious issue might be a matter that not only requires significant consideration or consultation but also leads to significant points of disagreement, debate or deliberation between the auditor and management. Regardless of whether the issue is difficult or contentious, some outreach participants indicated that they would like information concerning how management and the auditor ultimately resolved the issue in order for the auditor to issue an unqualified opinion.

In addition, some outreach participants suggested the auditor should discuss the "close calls" encountered by the auditor in performing the audit. Some investors described close calls to include matters such as –

- Those accounting decisions that required significant deliberation by the auditor and management before being deemed to be acceptable within the applicable financial accounting framework,
- Those matters related to internal control over financial reporting that required significant deliberation by the auditor and management, and
- A financial statement issue that had a potential material impact to the financial statements and was corrected prior to the end of the period.

Some outreach participants indicated that knowing the difficult or contentious issues or the close calls would provide insight into the auditor's significant judgments. Others suggested that the auditor provide a listing of the issues in the auditor's report (e.g., difficult, contentious, or close calls) without the auditor's views. Based on this information, financial statement users could determine if further investigation is warranted as part of their investment analysis.

However, other outreach participants believe that if the difficult or contentious issues, or "close calls" are resolved to the auditor's satisfaction then description of them in the auditor's report would not provide relevant and useful information and could be misleading regarding the meaning of the auditor's opinion (i.e., the issuance of an



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unqualified opinion demonstrates that the auditor has satisfactorily resolved all material matters).

Some outreach participants indicated that due to the financial complexity of most public companies and their many accounting policies and estimates, there are typically a significant number of difficult or contentious issues or close calls in the normal course of the audit. Therefore, it may be hard for the auditor to determine which particular issues are most important to be discussed in the auditor's report.

### *4. Information Communicated to the Audit Committee*

Some outreach participants indicated that the auditor should include in, or attach to, the auditor's report the auditor's communications with the audit committee. Much of the information communicated to the audit committee includes matters previously discussed, such as risks, audit procedures and results, and the quality of the financial statements. Some outreach participants indicated that the audit committee communication could provide key insights into the quality of the financial statements and internal control over financial reporting, and provide the auditor's views regarding significant accounting matters.

Other outreach participants, however, expressed concern that the two-way dialogue that takes place between the auditor and the audit committee cannot be replicated in the auditor's report, and a written report would not provide sufficient context to aid understanding of the matters presented in the audit committee communications by someone outside the company. For example, audit committee members have the opportunity to ask probing questions of the auditor regarding the information provided to enhance their understanding of the communications, when needed. Some outreach participants noted that having an auditor provide all audit committee communications to investors might stifle the communications between the auditor and the audit committee and undermine the governance role of the audit committee.

Other outreach participants said that the nature and extent of the audit committee communications vary considerably. The communications may be oral or written and may vary in length from an executive summary to a 100-page detailed document. These outreach participants indicated that disclosure of these communications may lead to a lack of comparability among companies. Further, audit committee communications often include company- and industry-specific terms that audit committee members understand in their oversight role, but might require greater context or explanation in order for these terms to be understood outside of the company.

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### 5. *Other Information Outside the Financial Statements*

Many outreach participants have indicated that the auditor should provide some level of assurance on information outside the financial statements (e.g., MD&A, earnings releases, non-GAAP information). Their view is that investors use and place reliance on other financial information (e.g., earnings releases), in addition to the historical financial statements. Some outreach participants indicated that other information outside the financial statements contains valuable information about the company, and provides additional context for understanding and interpreting the audited financial statements. Some indicated that an auditor providing some level of assurance on this information would improve the quality, completeness, and credibility of such information.

Under auditing standards the auditor has certain responsibilities with respect to other information (i.e., MD&A) in documents containing the audited financial statements (i.e., annual report). In this case, AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires the auditor to read the other information and to consider whether that information is materially inconsistent with the information appearing in the audited financial statements and whether there is a material misstatement of fact.<sup>17/</sup> However, under existing auditing standards the auditor does not have responsibility with respect to certain information not contained in the annual report, such as in a company's earnings releases. Although, the audit committee could retain the auditors to perform agreed-upon procedures on this information.<sup>18/</sup>

The MD&A, earnings releases, and other documents often include non-GAAP information. Some outreach participants suggested that if an auditor were required to provide some level of assurance on such information, then suitable criteria would need to be developed for the preparation and presentation of non-GAAP information to ensure the integrity and consistency of the reporting. These participants are concerned that auditors would constrain management's discussion to only matters that can be objectively verified by the auditor, and therefore limit management in its communication with the investor.

Some outreach participants acknowledged that various recommendations might require collaboration with the SEC, to mandate changes to current financial reporting

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<sup>17/</sup> AU sec. 550.

<sup>18/</sup> See AT sec. 201, *Agreed-Upon Procedures Engagements*.

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requirements and development of a management reporting framework. These recommendations include expanding the auditor's responsibility related to other financial information to include an audit or review of MD&A, press releases, and non-GAAP information.

### D. Clarification of the Standard Auditor's Report

Many investors suggested that certain language within the standard auditor's report should be further clarified or explained. These investors suggested that clarifying the language in the standard auditor's report could improve the user's understanding of what an audit represents and the various responsibilities of the auditor and management as part of the audit process.

#### 1. *Reasonable Assurance*

Some outreach participants indicated that the concept of an auditor's report providing "reasonable assurance" that the financial statements are free of material misstatement is not clearly understood. The auditor's report explicitly asserts that the audit was conducted in accordance with professional standards and states that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."

Some outreach participants suggested that the auditor's report should describe the meaning of reasonable assurance consistent with how it is described in the auditing standards (i.e., clarify the language in the auditor's report that reasonable assurance is a high level of assurance, but not absolute assurance).

The term "reasonable assurance," as used in auditing standards, describes the level of assurance that auditors are required to obtain by performing audit procedures and evaluating the resulting audit evidence when expressing an audit opinion. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. Therefore, an audit may not detect a material misstatement.<sup>19/</sup>

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<sup>19/</sup> Paragraph 10 of AU sec. 230, *Due Professional Care in the Performance of Work*.

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### 2. *Auditor's Responsibility for Fraud*

Many outreach participants indicated that the auditor's report should provide clarification regarding the auditor's responsibility related to fraud. For example, the current standard auditor's report does not mention "fraud" and is silent about the auditor's responsibility to detect fraud.<sup>20/</sup>

The auditing standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.<sup>21/</sup>

### 3. *Auditor's Responsibility for Disclosures*

Many outreach participants suggested that it would be beneficial to clarify in the auditor's report that audited disclosures are part of the financial statements and therefore are equally subject to the audit. The standard auditor's report identifies the balance sheets, related statements of operations, stockholders' equity and cash flows as the financial statements. Additionally, the SEC rules provide that "financial statements" include all notes to the financial statements and related schedules.<sup>22/</sup>

Some outreach participants indicated that the auditor's evaluation of audit results should include evaluation of the presentation of the financial statements, including disclosures.<sup>23/</sup> Many outreach participants indicated that the increasing level of disclosures required due to the complexity of business transactions, off-balance sheet transactions, non-recognition of assets and liabilities, and the increased use of fair value and other accounting estimates underscore why the auditor's report should explicitly state that the audit opinion also extends to audited disclosures.

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<sup>20/</sup> ACAP Final Report, p. VII.14.

<sup>21/</sup> AU sec. 230 and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>22/</sup> Rule 1-01(b) of Regulation S-X, 17 CFR §210.1-01.

<sup>23/</sup> Paragraph 4.e. of Auditing Standard No. 14, *Evaluating Audit Results*.

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Overall there is consensus among outreach participants that the auditor's report should explicitly state that the financial statements, including the related disclosures, are subject to the audit and auditor's opinion.

Under auditing standards, auditors are required to perform procedures to test the financial statement disclosures and to evaluate whether the financial statements contain the information essential for fair presentation of the financial statements in conformity with the applicable financial reporting framework.<sup>24/</sup> Auditing standards also require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional<sup>25/</sup> to identify and test significant disclosures;<sup>26/</sup> and, in integrated audits, to test controls over significant disclosures.<sup>27/</sup>

### 4. *Management's Responsibility for the Preparation of the Financial Statements*

Many outreach participants suggested that the auditor's report should make clear that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

The Sarbanes-Oxley Act of 2002 (the "Act") requires corporate officers to certify in periodic filings with the SEC that "based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer, as of, and for, the periods presented in the report."<sup>28/</sup> This requirement denotes that management is responsible for the fair presentation of the company's financial statements.

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<sup>24/</sup> Paragraphs 30-31 of Auditing Standard No. 14.

<sup>25/</sup> See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

<sup>26/</sup> See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements.

<sup>27/</sup> Paragraph 26 of Auditing Standard No. 5.

<sup>28/</sup> Section 302(a)(3) of the Act.

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### 5. *Auditor's Responsibility for Information Outside the Financial Statements*

Some outreach participants indicated that users of financial statements misinterpret the auditor's responsibilities regarding information presented outside the financial statements. Such information might be financial or non-financial information included in the MD&A or presented in other portions of documents containing audited financial statements. These outreach participants suggested that the auditor specifically state in the auditor's report the auditor's responsibility and procedures, if any, related to such information.

While the audit does not extend to information outside the financial statements, the auditor has certain responsibilities with respect to such information. Specifically, auditing standards require the auditor to read the information and to consider whether that information is materially inconsistent with the information appearing in the audited financial statements and whether there is a material misstatement of fact.<sup>29/</sup> However, they indicated that the auditor has no obligation to perform any procedures to corroborate the other information contained in the document. If no material inconsistencies or material misstatements of fact are found, the auditor's report would not address this information.

### 6. *Auditor Independence*

Some outreach participants indicated that it would be useful if the auditor explicitly stated in the auditor's report that he or she is independent with respect to the company. An explicit statement in the auditor's report could clarify for the investor the auditor's responsibility to be independent.

Other outreach participants indicated that the title of the standard auditor's report (Report of Independent Registered Public Accounting Firm) conveys compliance with the independence rules and suggested that additional discussion regarding independence could be redundant.

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AU sec. 550.