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## **I. Introduction**

The auditor's report is the primary means by which the auditor communicates with investors and other financial statement users information regarding his or her audit of the financial statements. As it exists today, the auditor's report identifies the financial statements that were audited, describes the nature of an audit, and presents 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. This type of 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).<sup>1/</sup>

The auditor's report in the United States has changed very little since the 1940s. The existing pass/fail model is thought by many to be useful because it provides a clear indication of whether the financial statements are presented fairly.<sup>2/</sup> However, while the existing auditor's report provides important information about an audit in general, it does not provide information that is specific to a particular audit.

Academic research suggests that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified

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<sup>1/</sup> If the financial statements are not fairly presented, the standards of the PCAOB provide that an auditor may issue a qualified opinion, adverse opinion, or disclaimer of opinion.

<sup>2/</sup> See paragraph (c) of U.S. Securities and Exchange Commission ("SEC") Rule 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02. SEC rules require the accountant to clearly express an opinion on the audited financial statements that are required to be filed as part of registration statements under the Securities Act of 1933 ("Securities Act") and Section 12 of the Securities Exchange Act of 1934 ("Exchange Act"), annual or other reports under Sections 13 and 15(d) of the Exchange Act, proxy and information statements under Section 14 of the Exchange Act, and registration statements and shareholder reports under the Investment Company Act of 1940. See also paragraph (a) of SEC Rule 1-01 of Regulation S-X, 17 C.F.R. § 210.1-01.

because it does not provide any other informational value about the particular audit.<sup>3/</sup> During the Board's outreach activities over the last three years, many investors have expressed dissatisfaction that the content of the existing auditor's report provides little, if any, information specific to the audit of the company's financial statements to investors or other financial statement users. During a financial statement audit, auditors obtain and evaluate important information concerning the company, the company's environment, and the preparation of the company's financial statements. Many investors have indicated that they would benefit from additional auditor reporting because they do not have access to, or may not be aware of, much of this information. Additionally, many investors indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the auditor's report to make the reports more relevant and useful.<sup>4/</sup>

Several commissions examined both the auditor's responsibilities and the form of the auditor's report in the 1970s and 1980s.<sup>5/</sup> These commissions made several recommendations to change the auditor's report; however, only a limited number of changes were made in response to these recommendations.<sup>6/</sup> In 2008, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession ("ACAP") recommended that the PCAOB undertake a standard-setting initiative to consider

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<sup>3/</sup> See, e.g., Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); and Theodore J. Mock, Jean Bedard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing 323, 323-351 (2013).

<sup>4/</sup> See survey, *Improving the Auditor's Report*, which was presented by the working group of the IAG on Auditor's Report and The Role of the Auditor, (March 16, 2011), available at [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

<sup>5/</sup> For example, in 1978, the Commission on the Auditors' Responsibilities (known as the "Cohen Commission") and in 1987, the National Commission on Fraudulent Financial Reporting (known as the "Treadway Commission") recommended changes to the auditor's report.

<sup>6/</sup> The changes expanded the discussion of attributes of an audit and management's responsibility. See Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts to Influence the Auditing Standards Board*, 1 (1993), 38.

improvements to the auditor's standard reporting model.<sup>7/</sup> The ACAP report noted that "some believe...[that the] standardized wording does not adequately reflect the amount of auditor work and judgment."<sup>8/</sup> Similar sentiments were expressed more recently by members of the Board's Standing Advisory Group ("SAG")<sup>9/</sup> and IAG.<sup>10/</sup>

Additionally, ACAP noted that the auditor reporting model developed in the 1940s did not address the increasing complexity of global business operations that 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>11/</sup> It was further noted that this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.<sup>12/</sup> ACAP concluded that an improved auditor's report likely would lead to more relevant information for users of financial statements and would clarify the role of the auditor in the financial statement audit.<sup>13/</sup>

During the Board's outreach activities, some investors noted that auditors gain knowledge about the company's financial statements during the audit that is not known to investors. These investors stated that they believe such knowledge would assist them when making their investment decisions. Academic research finds that the existing

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<sup>7/</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* ("ACAP report"), at VII:13 (October 6, 2008), available at <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>.

<sup>8/</sup> Id. at VII:13.

<sup>9/</sup> See SAG meeting details and webcast for April 2010 available at [http://pcaobus.org/News/Events/Pages/04072010\\_SAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx).

<sup>10/</sup> See IAG meeting details and webcast for May 2010 and March 2011 available at [http://pcaobus.org/News/Events/Pages/05042010\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/05042010_IAGMeeting.aspx) and [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

<sup>11/</sup> See ACAP Report at VII:17.

<sup>12/</sup> Id.

<sup>13/</sup> Id.

auditor's report has symbolic value in that it represents the auditor's work but that it provides little communicative value.<sup>14/</sup>

Additionally, the auditor's report is undergoing change globally. Several international standard setters and regulators, such as the International Auditing and Assurance Standards Board ("IAASB"), the United Kingdom's Financial Reporting Council ("FRC"), and the European Commission ("EC") have been working on similar projects to change the auditor's report.<sup>15/</sup>

After extensive outreach conducted over the last three years, the Board is proposing two standards under its statutory mandate to "protect the interests of investors and further the public interest in the preparation of *informative*, accurate and independent audit reports"<sup>16/</sup> [emphasis added]. The proposed standards are intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. At the same time, the Board sought a balanced approach that would not unduly burden the financial reporting process.

The two proposed standards are: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"). The Board also is proposing related amendments to other PCAOB auditing standards (the "proposed amendments"). This release collectively refers to the proposed auditor reporting standard, proposed other information standard, and proposed amendments as "the proposed standards and amendments."

Briefly, the Board's proposed auditor reporting standard would retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" that

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<sup>14/</sup> See Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008).

<sup>15/</sup> See further discussion regarding the projects of these standard setters and regulators in Section II., *Board Outreach*.

<sup>16/</sup> Section 101(a) of the Sarbanes-Oxley Act of 2002 (the "Act").



would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

The auditor's report as currently designed, and as confirmed by academic research, conveys to investors and other financial statement users little of the information obtained and evaluated by the auditor.<sup>17/</sup> The proposed auditor reporting standard is intended to provide investors and other financial statement users with potentially valuable information that investors have expressed interest in receiving but have not had access to in the past.<sup>18/</sup>

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry<sup>19/</sup> that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.<sup>20/</sup> The Board is

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<sup>17/</sup> See Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 *Accounting Horizons* 69, 70 (2008).

<sup>18/</sup> See CFA Institute's surveys: *Usefulness of the Independent Auditor's Report* (May 4, 2011), *Independent Auditor's Report Survey Results* (February 26, 2010), and *Independent Auditor's Report Monthly Poll Results* (March 12, 2008), available at <http://www.cfainstitute.org/about/research/surveys/pages/index.aspx>.

<sup>19/</sup> Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

<sup>20/</sup> See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553, 1553-1583 (2004).

seeking comment on whether the information communicated in critical audit matters would be valuable to investors and could reduce information asymmetry.

The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. In considering the nature and form of auditor reporting on other information, the Board evaluated the existing auditing standard related to the auditor's responsibilities with respect to other information and determined it was appropriate to update the other information standard to support a description in the auditor's report. The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors. "Other information" in the proposed other information standard refers to information in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report. The proposed enhancements to the required auditor's procedures in the proposed other information standard are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,<sup>21/</sup> or intentional misreporting.<sup>22/</sup> As a result of the

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<sup>21/</sup> See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 *Journal of Accounting and Economics* 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting*, Unpublished working paper (2013) available at <http://ssrn.com/abstract=929731>.

<sup>22/</sup> See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 *Journal of Accounting Research* 1135, 1135-1166 (2009).



auditor's evaluation of other information and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information<sup>23/</sup> available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors also could facilitate more efficient capital allocation decisions.<sup>24/</sup> Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.<sup>25/</sup> The Board is seeking comment on whether the proposed other information standard would increase the quality of information available to investors.

The Board anticipates that the proposed auditor reporting standard and proposed other information standard will have cost implications for both auditors and companies, including audit committees, as further discussed in this release and Appendices 5 and 6.

The remaining sections of this release describe the outreach conducted by the Board in considering possible changes to the auditor's report, the development and overview of the proposed standards and amendments, and alternatives considered. Additionally, this release includes a discussion of the applicability of the proposed standards and amendments to the audits of brokers and dealers and considerations regarding audits of emerging growth companies ("EGCs").

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<sup>23/</sup> The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 *Journal of Accounting Research* 1, 1-42 (1982).

<sup>24/</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1-29 (2011).

<sup>25/</sup> Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, refer to Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of Information Precision in Determining the Cost of Equity Capital*, 9 *Review of Accounting Studies* 233, 233-259 (2004).

## **II. Board Outreach**

Over the last three years, the Board has conducted extensive outreach with investors, auditors, financial statement preparers, and others to better understand the nature of improvements that could be made to make the auditor's report more informative. In developing its proposals, the Board also sought to better understand issues related to implementing improvements, including potential costs and other economic considerations involved.

From October 2010 through March 2011, the staff of the Board's Office of the Chief Auditor ("staff") met and held discussions with investors, financial statement preparers, auditors, audit committee members, other regulators and standard setters, and representatives of academia. During this outreach, 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. 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 potential risks of material misstatement in a company's financial statements. The staff reported its findings to the Board at an open meeting on March 22, 2011.<sup>26/</sup> The Board concluded from its initial outreach that changing the auditor's report could improve the informational value of the auditor's report and enhance the relevance of the auditor's reporting model. During this same period at an IAG meeting, the recent financial crisis was mentioned as an example of a situation in which expanded auditor reporting in advance of, and during, the crisis might have been helpful in assessing a company's financial statements and providing early warning signals regarding potential issues.<sup>27/</sup>

Subsequently, on June 21, 2011, the Board issued *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "concept release")<sup>28/</sup> to seek public

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<sup>26/</sup> See meeting details and webcast for PCAOB Board Meeting on March 22, 2011, available at [http://pcaobus.org/News/Webcasts/Pages/03222011\\_OpenBoardMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/03222011_OpenBoardMeeting.aspx).

<sup>27/</sup> See Investor Advisory Group ("IAG") meeting details and webcast for March 2011 available at [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

<sup>28/</sup> PCAOB Release No. 2011-003 (June 21, 2011) available at [http://pcaobus.org/Rules/Rulemaking/Docket034/Concept\\_Release.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf).

comment on potential changes to the auditor's reporting model. The objective of the concept release was to seek comment on several alternatives for changing the auditor's reporting model in order to make auditor reporting more relevant and useful to investors and other financial statement users. The alternatives presented were:

- A supplemental narrative report, described as an auditor's discussion and analysis ("AD&A");
- Required and expanded use of emphasis paragraphs;
- Auditor assurance on other information outside the financial statements; and
- Clarification of the standard auditor's report.

The concept release indicated that each of the alternatives presented would retain the pass/fail opinion of the existing auditor's report and was not intended to alter the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. The concept release also indicated that the alternatives were not mutually exclusive and that other alternatives could be considered.

The Board received 155 comment letters on the concept release.<sup>29/</sup> Additionally, on September 15, 2011, the Board held a public roundtable ("roundtable") to obtain insight from a diverse group of investors and other financial statement users, preparers of financial statements, audit committee members, and auditors on the alternatives presented in the concept release.<sup>30/</sup> The topic was further discussed at the November 2011 and 2012 SAG meetings.<sup>31/</sup>

Commenters generally supported the Board updating and enhancing the auditor reporting standard and largely agreed that the existing auditor's report provided little informational value about a specific audit to investors and other financial statement

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<sup>29/</sup> See comment letters on the concept release available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket034Comments.aspx>.

<sup>30/</sup> See transcript of the roundtable available at [http://pcaobus.org/Rules/Rulemaking/Docket034/09152011\\_Roundtable\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf).

<sup>31/</sup> See SAG meeting transcripts for November 2011 and 2012 available at [http://pcaobus.org/Rules/Rulemaking/Docket034/11102011\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf), [http://pcaobus.org/Rules/Rulemaking/Docket034/11162012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf), and [http://pcaobus.org/Rules/Rulemaking/Docket034/11152012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf).

users beyond the pass/fail opinion. However, there were widely diverse views among different constituencies about the nature and extent of changes that should be made to the existing auditor's report and the potential costs associated with those changes.

Investors strongly supported the Board's initiative to enhance the existing auditor's report to provide more informative reporting about the audit, the financial statements, or both. This group of commenters generally expressed the view that the existing auditor's report was not sufficiently informative to meet the needs of investors who would benefit from further insights obtained by the auditor during the audit of the financial statements. Investors most frequently suggested additional auditor reporting on the following information:

- Areas of high financial statement and audit risk;
- Areas of significant auditor judgment;
- The most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty;
- The quality, not just the acceptability, of accounting policies and practices, for instance, management's application of accounting policies that are acceptable under the applicable financial reporting framework but are not the preferred practice;
- Significant changes in or events affecting the financial statements, including unusual transactions; and
- Identification of where significant matters are disclosed in the financial statements for investors' further information.

Some investors recognized that, if the auditor's report included this information, audit costs could increase due to the time required to draft and review such communications. However, these investors also expressed the belief that these costs, which are ultimately paid for by investors, likely would be modest since the communication would be based on the work already performed by the auditor. These commenters indicated that the benefits in terms of increased confidence in corporate reporting outweighed the costs.

Financial statement preparers, in general, did not object to the clarifications to the auditor's report described in the concept release if such clarifications would be useful to financial statement users and would increase the transparency into the audit

process. The majority of these commenters, however, believed that there was little need for changes to the existing auditor's report and believed it was the responsibility of the company, not the auditors, to provide information about the company's financial statements to financial statement users. Audit committee members expressed similar views.

Auditors generally were supportive of changes to the existing auditor's report but believed that any additional auditor reporting should be objective and factual. This group of commenters also believed that certain changes to the auditor's report could provide benefits to users of the financial statements by providing additional clarification about the audit and audit process. Auditors noted that the alternatives presented in the concept release for changing the auditor's report would require additional effort, primarily related to drafting and reviewing the auditor's report, and as a result would increase audit costs and the potential for auditor liability.

Other commenters, including academics, other regulators, and other individuals and organizations, expressed a variety of views about changes to the existing auditor's report. For example, one commenter indicated that the existing auditor's report is not particularly informative and does not provide information regarding the nature and type of procedures, processes, and information used in forming the auditor's opinion. Other commenters indicated that the current pass/fail model is sufficient and that it is the responsibility of the company, and not the auditors, to provide additional disclosures about the company to investors.

One of the alternatives presented in the concept release was to require auditor assurance on other information outside the financial statements. Some commenters noted that they were uncertain as to the level of the auditor's responsibility for other information outside the financial statements. Some of those commenters supported changes to the auditor's report that describe the auditor's existing responsibilities related to information outside the financial statements to inform investors and other financial statement users of the extent of the auditor's responsibility for other information contained in a document that also contains the financial statements and the related auditor's report. A number of commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed, in addition to the description of the auditor's responsibilities regarding other information outside the financial statements.

In developing the proposed auditor reporting standard, the Board considered recent developments of (1) the IAASB's project on auditor reporting;<sup>32/</sup> (2) the EC's

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<sup>32/</sup> See IAASB project summary at <http://www.ifac.org/auditing-assurance/projects/auditor-reporting>. The IAASB issued an exposure draft, *Reporting*

legislative proposal and subsequent European Parliamentary report that relate to audits of public interest entities,<sup>33/</sup> and (3) the FRC's recently adopted revision of its auditing standard on the auditor's report.<sup>34/</sup> The IAASB's project, the EC's proposal and subsequent amendments, and the FRC's revised auditing standard would require auditor reporting on certain additional matters.

In developing the proposed other information standard, the Board considered the IAASB's recent proposal, *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*.<sup>35/</sup>

### **III. Development and Overview of the Proposals**

In developing the proposed standards and amendments, the Board considered (1) the information communicated in the current auditor's report; (2) the potential benefits that may result from auditors providing additional communications; (3) the potential costs related to the approach proposed by the Board; (4) alternative approaches (which are discussed in Section IV., *Alternatives Considered*); (5) current developments in similar projects by other standard setters; (6) relevant academic

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*on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*, for public comment in July 2013 available at <https://www.ifac.org/publications-resources/reporting-audited-financial-statements-proposed-new-and-revised-international>.

<sup>33/</sup> See proposal for a *Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities* (November 30, 2011) available at [http://ec.europa.eu/internal\\_market/auditing/docs/reform/regulation\\_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf). See amendments to the EC proposal that were approved on May 14, 2013, by the Parliamentary committee with principal jurisdiction over the proposal at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bREPORT%2bA7-2013-0171%2b0%2bDOC%2bXML%2bV0%2f%2fEN&language=EN>.

<sup>34/</sup> See FRC's revised auditor reporting standard at [http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-\(UK-and-Ireland\)-700-\(Revised\).aspx](http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-(UK-and-Ireland)-700-(Revised).aspx).

<sup>35/</sup> See IAASB project summary at <http://www.ifac.org/auditing-assurance/projects/auditors-responsibilities-relating-other-information-documents-contains>.



research; and (7) significant comments received by the Board from its outreach efforts, including comments received on the concept release. In considering the nature and extent of changes to the existing auditor's report, the Board sought to respond to the needs of investors and other financial statement users by making the auditor's report more informative while not adding undue burden to the financial reporting process.

#### **A. Proposed Auditor Reporting Standard**

The proposed auditor reporting standard, among other things, would make the following significant changes to the existing auditor's report:

- Require the auditor to communicate in the auditor's report critical audit matters that were addressed during the audit of the current period's financial statements. If the auditor determines that there are no critical audit matters, the auditor would state in the auditor's report that the auditor determined that there are no such matters to communicate.
- Add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report.
- Enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.

The proposed auditor reporting standard would retain the pass/fail model of the existing auditor's report. The proposed auditor reporting standard would also retain explanatory paragraphs that are required in certain circumstances and the auditor's ability to emphasize a matter in the financial statements.

##### *1. Auditor Reporting of Critical Audit Matters*

In developing the proposed requirements for the communication of critical audit matters, the Board considered many investors' requests for information regarding matters related to the audit and the most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty. The concept release described as alternatives for providing additional information to financial statement users about the audit and the financial statements: (1) an AD&A and (2) required and expanded emphasis paragraphs. The

Board, however, is not proposing any of these alternatives, which are described further in Section IV., *Alternatives Considered*.

The Board, instead, is proposing requirements for the auditor to communicate in the auditor's report "critical audit matters." Critical audit matters are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Use of the word most is not intended to imply that only one matter under each criteria would qualify as a critical audit matter.

The Board is proposing communication of critical audit matters in response to the requests of many investors to improve the relevance of the auditor's report by providing more insight about the most significant matters that the auditor addressed in the audit. Communicating critical audit matters likely would provide meaningful information to investors and other financial statement users about the auditor's work in performing the audit and in forming an opinion on the financial statements, taken as a whole.

The auditor would determine which matters to communicate as critical audit matters. The proposed auditor reporting standard indicates that critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document,<sup>36/</sup> which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer;<sup>37/</sup> (3) communicated to the audit committee;<sup>38/</sup> or (4) any combination of the three. The Board would not expect that each matter included in any one or more of these sources would be a critical audit matter. Referring to these sources can provide a cost-effective and efficient means of determining critical audit matters. Additionally, the proposed auditor reporting standard provides a list of factors for the auditor to take into account in determining the critical audit matters. The factors are intended to help the auditor determine, from the results of the audit or evidence obtained, which matters are critical audit matters.

The auditor's communication of critical audit matters would be based on information known to the auditor and procedures that the auditor has already performed as part of the audit. Thus, the proposed auditor reporting standard does not modify the

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<sup>36/</sup> Auditing Standard No. 3, *Audit Documentation*.

<sup>37/</sup> Auditing Standard No. 7, *Engagement Quality Review*.

<sup>38/</sup> Auditing Standard No. 16, *Communications with Audit Committees*, and other PCAOB standards.

objective of the audit of the financial statements or impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

The proposed auditor reporting standard would require the auditor to determine critical audit matters in the audit of the current period's financial statements, based on the results of the audit or evidence obtained. The proposed auditor reporting standard also provides that in situations in which the auditor determines there are no critical audit matters to communicate, the auditor would state that conclusion in the auditor's report. Critical audit matters would be determined based on the facts and circumstances of each audit. It is expected that in most audits the auditor would determine that there are critical audit matters.

The description of critical audit matters in the auditor's report would:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.<sup>39/</sup> Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. A more informative auditor's report could benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

Improving the auditor's report through the communication of critical audit matters also would address some commenters' concerns that it is the company's or the audit committee's responsibility, not the auditor's, to provide information, including any analysis, about the company's financial statements to financial statement users. The

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<sup>39/</sup> See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 *Journal of Accounting and Economics* 337, 337-386 (2003).

proposed communication of critical audit matters would not fundamentally change the auditor's current role from attesting on information prepared by management. Rather, the auditor would be communicating information about the audit, based on audit procedures the auditor performed.

The Board intends for the proposed communication of critical audit matters to be responsive to cost issues raised by commenters. Because critical audit matters are based on the relative complexity and difficulty of the audit, the Board anticipates that the proposed auditor reporting standard would be scalable based on the size, nature, and complexity of the audit of the company. The Board also anticipates, however, that reporting of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees. In addition to the potential cost implications, there could be potential unintended consequences associated with requiring that auditors communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit which might reduce the time available to the auditor for review and completion of the audit work. The Board seeks comments on the nature and extent of those costs, as well as regarding any potential unintended consequences.

## *2. Basic Elements of the Auditor's Report*

The existing auditor's report identifies the financial statements audited, describes the nature of an audit, and expresses the auditor's opinion using standardized language. The existing auditor reporting standard also provides a list of basic elements that are required to be in the auditor's report.<sup>40/</sup>

The concept release sought comment on whether the standardized language in the auditor's report required by the existing auditing standard is useful, whether any of the language could be clarified, and whether the auditor's report should describe the auditor's responsibilities for other information outside the financial statements. Several commenters indicated that clarifying language and certain other matters in the auditor's report could improve financial statement users' understanding of the nature of an audit, the auditor's responsibilities, and the purpose of the auditor's report. Some commenters, however, indicated that additional boilerplate language to clarify language already in the report would not be helpful. After considering the comments, the Board is proposing certain clarifications of the language in the report that the Board believes would enhance users' understanding about the audit and the auditor, including the auditor's responsibilities for other information outside the financial statements.

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<sup>40/</sup> See AU secs. 508.06-.08.

The proposed auditor reporting standard primarily retains the basic elements of the auditor's report contained in existing auditor reporting standards,<sup>41/</sup> incorporates certain elements from existing illustrative auditor's reports, and further describes some of the auditor's existing responsibilities, such as the auditor's responsibility for the notes to the financial statements and fraud.

Additionally, the proposed auditor reporting standard adds the following new elements to the auditor's report to provide investors and other financial statement users with information about the audit and the auditor:

- Auditor independence – a statement regarding the auditor's existing requirements to be independent of the company, intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations;
- Auditor tenure – the year the auditor began serving as the company's auditor, to provide investors and other financial statement users with information about the length of the relationship between the auditor and the company; and
- Other information – the auditor's responsibilities for, and the results of, the auditor's evaluation of other information in annual reports filed with the SEC containing the financial statements and the related auditor's report, to provide investors and other financial statement users with an understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The Board anticipates that these proposed changes to the auditor's report likely would have some cost-related implications for auditors and companies, including audit committees. The Board seeks comments on the nature and extent of those costs.

### 3. *Explanatory Language*

Under existing PCAOB standards, certain circumstances require that the auditor include explanatory language or paragraphs in the auditor's report, such as when there

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<sup>41/</sup> See AU sec. 508 and Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board*.

is substantial doubt about the company's ability to continue as a going concern<sup>42/</sup> or the correction of a material misstatement in previously issued financial statements. These circumstances are described in other PCAOB standards, which generally provide standardized language to be included in the auditor's report. Similar to the existing auditor reporting standard, the proposed auditor reporting standard describes those circumstances and provides references to the relevant PCAOB standards.

Additionally, the proposed auditor reporting standard retains from the existing standard the auditor's ability to include explanatory paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Currently, such explanatory paragraphs are not required and may be added solely at the auditor's discretion.<sup>43/</sup> As described in the proposed auditor reporting standard, these explanatory paragraphs would refer only to information presented or disclosed in the financial statements. The proposed auditor reporting standard provides several examples of when an auditor might include such explanatory paragraphs.

## **B. Auditor's Responsibilities Regarding Other Information**

Other information outside the financial statements may be relevant to an audit of the financial statements or to the auditor's decision to be associated with the company's annual report. The proposed other information standard describes "other information" as information, other than the audited financial statements and the related auditor's report, included in a company's annual report that is filed with the SEC under the Exchange Act<sup>44/</sup> and contains that company's audited financial statements and the related auditor's report. For example, other information in an annual report filed by a company on Form 10-K would include, among other items, Selected Financial Data, Management's Discussion & Analysis ("MD&A"), exhibits, and certain information incorporated by reference.

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<sup>42/</sup> The Board is considering a separate standard-setting project to enhance performance requirements and auditor reporting related to a company's ability to continue as a going concern.

<sup>43/</sup> See AU sec. 508.19.

<sup>44/</sup> Consistent with existing AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, the proposed other information standard would not apply to documents filed with the SEC under the Securities Act that contain audited financial statements and the related auditor's report. See further discussion regarding Securities Act documents in Appendix 6.



Under existing PCAOB standards, the auditor has a responsibility to "read and consider" other information in certain documents that also contain the audited financial statements and the related auditor's report; however, there is no related reporting requirement to describe the auditor's responsibility with respect to other information.

The Board began considering the existing other information standard, AU sec. 550, as part of an effort to better explain to investors and other financial statement users the auditor's responsibilities related to other information outside the financial statements. Through that consideration, the Board determined that changes were appropriate to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

As a result of the link between the proposed auditor reporting standard and the proposed other information standard, the financial statement user would obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description of the results of the auditor's evaluation of the other information.

Under the existing other information standard, the auditor considers whether the other information is materially inconsistent with information in the financial statements. If the auditor concludes there is a material inconsistency between the other information and the financial statements, the existing standard provides the auditor with certain procedures to respond to the material inconsistency. Additionally, the existing standard provides that, if while reading the other information for a material inconsistency, the auditor becomes aware of a material misstatement of fact in the other information, the auditor would discuss this with management and perform other procedures based on the auditor's judgment.

The proposed other information standard, among other things, would:

- Apply the auditor's responsibility for other information specifically to a company's annual reports filed with the SEC under the Exchange Act that contain that company's audited financial statements and the related auditor's report;
- Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;

- Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements; and
- Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The Board's existing standard has no requirements for the auditor beyond "read and consider" with respect to the other information. In contrast, the proposed other information standard includes procedures that auditors consistently would perform in evaluating the other information. The Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard.

The Board notes that some of the other information not directly related to the audited financial statements might be non-financial in nature or related to the company's operations and, as a result, the auditor might not have obtained evidence or reached any conclusion regarding such information during the audit. The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.

In developing the proposed other information standard, the Board considered the additional effort and cost of implementing changes in the auditor's responsibilities regarding other information. The Board believes that the proposed approach represents a cost-sensitive approach that would be scalable to less complex companies based on the nature and extent of the information outside the financial statements for such companies as compared to companies with more extensive operations. The Board, however, anticipates that the proposed other information standard would have cost implications for auditors and companies, including audit committees. The Board requests comments regarding the nature and extent of those costs.

#### **IV. Alternatives Considered**

Before developing the proposed standards and amendments, the Board explored alternatives through extended outreach with investors, companies, auditors, audit committee members, and others. This outreach effort was followed by issuing the concept release in 2011, analyzing comment letters, holding a roundtable, and discussions with the SAG and IAG.

The concept release described alternatives for providing additional information to financial statement users about the audit and the financial statements, specifically: (1) an AD&A; (2) required and expanded emphasis paragraphs; (3) auditor assurance on other information outside the financial statements; and (4) clarification of the standard auditor's report. The following paragraphs explain the alternatives in the concept release. The Board, however, is not proposing any of these alternatives. The Board believes that its proposed approach, which includes communicating critical audit matters, provides many of the benefits described in the concept release while, at the same time, substantially reducing the challenges and costs mentioned by commenters, as explained in Section E., *Approach Proposed by the Board*, below.

The Board also considered retaining existing AU sec. 508 related to the unqualified report and issuing a staff practice alert or other guidance regarding the potential use of existing emphasis paragraphs. The Board believes, however, that proposing a new standard with changes to the auditor's report is appropriate in relation to its mandate under the Act to promote *informative*, accurate, and independent audit reports<sup>45/</sup> [emphasis added]. Additionally, the Board considered retaining AU sec. 550 and describing the auditor's responsibilities under AU sec. 550 in the auditor's report. The Board believes that issuing a new standard regarding the other information is appropriate because the proposed other information standard would provide a consistent basis for the auditor's evaluation of the other information and related auditor reporting.

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

As described in the concept release, an AD&A could provide investors with a view of the audit and the financial statements "through the auditor's eyes." The intent of the AD&A alternative was to provide the auditor with the ability to write a separate, supplemental narrative report that would follow the auditor's report on the financial statements and contain an open-ended discussion of the auditor's perspectives about the audit and the company's financial statements. The concept release describes the AD&A as being among the most expansive forms of auditor reporting.

According to the concept release, an AD&A could include information about the audit, such as audit risk identified in the audit, audit procedures and results, and auditor independence, and provide the auditor with the ability to communicate to investors and other users of the financial statements the auditor's significant judgments in forming the audit opinion. The AD&A, however, also could include the auditor's perspectives regarding the company's financial statements, such as management's judgments and

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<sup>45/</sup> See Section 101(a) of the Act.

estimates, accounting policies and practices, and difficult or contentious issues. Also, as described in the concept release, 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. In that regard, the concept release noted that the auditor's perspectives in an AD&A on certain matters could differ from those management might provide in its MD&A,<sup>46/</sup> possibly requiring additional time by management, the auditor, and the audit committee to resolve those differences before any views could be reflected in an AD&A or the MD&A.

Many investors indicated that additional information through an AD&A would provide more transparency into the audit and the financial statements. One commenter suggested that factors that would affect the way an auditor assesses risks of material misstatement in the financial statements might also affect how an investor views risks of investing in the company. Some commenters indicated that an AD&A would heighten the perceived value of the audit, increase competition among auditors based on audit quality, particularly with respect to auditor skepticism, and provide the firms more leverage to affect change and enhance management disclosure in the financial statements.

Other commenters, however, expressed reservations about an AD&A, as described in the concept release, primarily because they saw this form of supplemental narrative reporting as fundamentally changing the auditor's current role from attesting on information prepared by management to providing an analysis of financial statement information. These commenters were also concerned about possible undue reliance by financial statement users on an AD&A-type report to make investment decisions and the additional effort by auditors to write and review an AD&A in a compressed reporting timeframe. Some commenters were concerned that this type of auditor reporting could diminish the governance role of the audit committee over the company's disclosure of financial information by allowing auditors to make independent disclosures about the company's financial statements. Some commenters noted that an AD&A-type reporting would require auditors to draft customized language in a supplemental free-form report for public use. Additionally, commenters also noted that absent an extension from the SEC of filing and reporting deadlines, an AD&A would reduce the time available to the most senior members of the audit team for review and completion of audit work in order to identify matters to be included in an AD&A, draft customized language, and work with centralized review personnel to complete the review process.

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<sup>46/</sup> See SEC Regulation S-K, Item 303; 17 CFR § 229.303.

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

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>47/</sup> As described in the concept release, required and expanded emphasis paragraphs could highlight the most significant matters in the financial statements and identify where these matters are disclosed in the financial statements. The concept release indicated that 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. The alternative in the concept release for required and expanded emphasis paragraphs was intended to provide investors with enhanced auditor reporting on much of the information investors indicated they want about the audit and the financial statements. As also explained in the concept release, for each matter of emphasis the auditor could be required to comment on the key audit procedures performed pertaining to the identified matters. The concept release indicated that this alternative was somewhat analogous to the French requirement that the auditor's report contain a "justification for the auditor's assessments."<sup>48/</sup>

Many commenters were supportive of using emphasis paragraphs to highlight significant matters to a reader, such as areas with significant management judgments and estimates or a high level of measurement uncertainty. Some commenters supported an emphasis paragraph approach that would inform financial statement users about important matters on which to focus in the financial statements for purposes of their investment decisions.

Many investors indicated that they did not support an auditor's report that only references the relevant financial statement disclosures because no incremental information would be provided in the emphasis paragraphs regarding the company's financial statements or the audit beyond what is already disclosed by management. Some other commenters noted that emphasis paragraphs raised concerns regarding the auditor's disclosure of original information that is not otherwise publicly known.

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<sup>47/</sup> See AU sec. 508.19.

<sup>48/</sup> On August 1, 2003, article L823-9 of the French Code of Commerce Financial security law was enacted, which requires that the statutory auditor include in the auditor's report a "justification of the auditor's assessments."

Additionally, at the November 2012 SAG meeting, SAG members discussed a potential approach to amending the auditor's reporting model that would include required emphasis paragraphs, based on the matters communicated to the audit committee under Auditing Standard No. 16.<sup>49/</sup> Some SAG members were supportive of linking auditor reporting in expanded emphasis paragraphs to matters communicated to the audit committee under Auditing Standard No. 16.<sup>50/</sup> Other SAG members did not support expanded emphasis paragraphs that would be specifically linked to communications with the audit committee because, in their view, it might affect the nature and extent of the communications between the auditor and the audit committee.<sup>51/</sup>

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

The concept release indicated that an alternative for enhanced auditor reporting could be auditor examination of, and reporting on, information outside the financial statements, such as MD&A or other selected information (for example, non-GAAP information or earnings releases). Some commenters indicated that certain information outside the financial statements, especially the MD&A, is important to investors to provide context within which the financial results and financial position can be interpreted.

However, investors generally were not supportive of auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model because it would not be responsive to their information needs, and they saw little benefit with this type of auditor assurance. Several commenters expressed concern that auditor assurance on information outside the financial statements would increase the time needed to perform these procedures and would not provide greater benefit than the auditor's current responsibilities related to other information outside the financial statements.

Several commenters suggested that they would support changes to the auditor's report that described the auditor's existing responsibilities related to other information and the auditor's conclusions related to the other information.

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<sup>49/</sup> See Briefing Paper: Auditor's Reporting Model available at [http://pcaobus.org/Rules/Rulemaking/Docket034/2012\\_11\\_15\\_SAG\\_BP\\_ARM.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/2012_11_15_SAG_BP_ARM.pdf).

<sup>50/</sup> See SAG meeting transcripts for November 2012 available at [http://pcaobus.org/Rules/Rulemaking/Docket034/11162012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf), and [http://pcaobus.org/Rules/Rulemaking/Docket034/11152012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf).

<sup>51/</sup> *Id.*



## **D. Clarification of Terms and Responsibilities in the Auditor's Report**

### *1. Reasonable Assurance*

In the concept release, the Board sought comment on whether the term "reasonable assurance" should be further described in the auditor's report. Under existing AU sec. 508, the auditor's report explicitly asserts that the audit was conducted in accordance with the standards of the PCAOB and 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." An existing auditing standard describes reasonable assurance as being a "high level of assurance, but not absolute assurance."<sup>52/</sup>

Commenters generally did not support adding additional language to the auditor's report that would further explain the term "reasonable assurance." Commenters suggested that adding additional language would not significantly enhance financial statement users' understanding of the meaning of the term "reasonable assurance."

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

In the concept release, the Board sought comment on whether the auditor's report should state that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

Under existing auditing standards, the standard 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>53/</sup>

Some commenters supported clarification in the auditor's report with respect to management's responsibility for the preparation of the financial statements. These commenters indicated that some clarifying language could improve investors' and other financial statement users' understanding of management's responsibilities for the preparation of the financial statements. Conversely, other commenters were against such a clarification, stating that additional language is unnecessary because similar language is already included in the auditor's report and the SEC requires corporate officers' certification of the financial statements.

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<sup>52/</sup> See paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*.

<sup>53/</sup> See AU sec. 508.08.c.

Because the existing language in the auditor's report is generally understood to encompass management's responsibility for both the preparation and fair presentation of the financial statements, the Board is not proposing to modify the auditor's report in this regard.

#### **E. Approach Proposed by the Board**

The Board believes the proposed auditor reporting standard and the proposed other information standard provide many of the benefits described in the concept release regarding an AD&A, required and expanded emphasis paragraphs, and auditor assurance on information outside the financial statements. The Board also believes that its proposed approach should eliminate or reduce some of the challenges mentioned by commenters in connection with the alternatives described in the concept release.

Unlike emphasis paragraphs as described in existing AU sec. 508 that generally just point to a disclosure in the company's financial statements, the proposed auditor reporting standard would require the auditor to communicate a wider range of information about the audit. Specifically, the proposed communication of critical audit matters would provide information regarding the reason the matter or matters were considered critical.

The proposed communication of critical audit matters would not fundamentally change the auditor's current role from attesting on information prepared by management to providing an analysis of financial statement information, which was one of the concerns expressed by commenters about an AD&A. Since the auditor would be communicating information regarding the audit, the communication of critical audit matters should not diminish the governance role of the audit committee over the company's disclosure of financial information. In addition, the proposed auditor reporting standard is intended to represent a cost-sensitive approach, because the auditor's determination of critical audit matters is based on the audit already performed.

The description in the auditor's report about the auditor's responsibilities for, and results of, the auditor's evaluation of other information is intended to provide greater clarity regarding the auditor's responsibilities for other information and the results of the auditor's evaluation of other information. Finally, the proposed other information standard would provide a specific basis for the auditor describing in the auditor's report the auditor's responsibilities for, and results of, the auditor's evaluation of other information.

## **V. Audits of Brokers and Dealers**

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")<sup>54/</sup> expanded the authority of the Board to oversee the audits of brokers and dealers that are required under SEC rules. On July 30, 2013, the SEC amended SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.<sup>55/</sup> At the publication date of this release, the final SEC rules have not been published in the Federal Register.

The Board will consider, and is soliciting comments on, whether the proposed standards and amendments are appropriate for audits of brokers and dealers. Appendices 5 and 6 include specific questions on the applicability of the proposed standards and amendments to the audits of brokers and dealers.

## **VI. Economic Considerations**

Economic considerations related to the proposed standards are noted in this release with Appendices 5 and 6 providing further discussion regarding the economic considerations related to each proposed standard. Appendix 7 provides further discussion of economic considerations specifically related to the audits of EGCs.

## **VII. Audits of Emerging Growth Companies**

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."<sup>56/</sup>

In connection with its proposals, the Board solicits views of commenters on the application of the proposed standards and amendments to audits of EGCs. As part of

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<sup>54/</sup> Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

<sup>55/</sup> See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

<sup>56/</sup> See Section 103(a)(3)(a) of the Act.

considering the potential application of the proposed standards to the audits of EGCs, the Board specifically requests comments, including information and data, to the extent available, relevant to issues relating to efficiency, competition, and capital formation, as well as the benefits and costs associated with its proposals.

#### **VIII. Effective Date**

The proposed standards and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board seeks comment on the effective date related to each proposed standard in Appendices 5 and 6. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposals as well as the timing of Board adoption of any final standard and amendments.

#### **IX. Appendices**

The Board's proposal includes this Release ("Release") and the following appendices:

- Appendix 1 contains the text of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.
- Appendix 2 contains the text of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.
- Appendix 3 contains amendments related to the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to other PCAOB standards.
- Appendix 4 contains amendments related to the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, to other PCAOB standards.
- Appendix 5 provides additional discussion of the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and the related amendments. Specific questions for commenters are included throughout this Appendix.

- Appendix 6 provides additional discussion of the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and the related amendments. Specific questions for commenters are included throughout this Appendix.
- Appendix 7 discusses certain other considerations related to audits of EGCs. Specific questions for commenters are included at the end of this Appendix.

Appendices 5 and 6 discuss significant comments received during the Board's outreach, provide additional background information regarding the requirements in the proposed standards and proposed amendments, and contain specific questions for commenters. Appendix 7 contains a discussion of certain considerations regarding the applicability of the proposed standards and the related amendments to the audits of EGCs and also includes specific questions for commenters.

#### **X. Opportunity for Public Comment**

The Board is seeking comment on all aspects of the proposed standards and amendments as well as on the specific questions included in Appendices 5, 6, and 7. Among other things, the Board is seeking comment on economic considerations relating to the proposed standards and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters, regarding the proposed standards and amendments. Commenters providing cost estimates are requested to provide the basis for any estimate provided. The Board is also requesting that commenters prepare, and forward to the Board for its consideration, examples of critical audit matters that could be communicated in the auditor's report under the proposed auditor reporting standard.<sup>57/</sup>

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at: [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to the PCAOB Rulemaking Docket Matter No. 034 on the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on December 11, 2013.

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<sup>57/</sup> Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

The Board will consider all comments received. The Board is considering holding a public roundtable in 2014 to discuss the proposed standards and comments received. If the Board decides to hold a public roundtable, the Board will reopen the comment period related to the proposed standards and amendments.

Following the close of the comment period(s), the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Act.

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On the 13th day of August, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown

Secretary



## **APPENDIX 1**

### **Proposed Auditing Standard**

#### ***The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

##### ***Introduction***

1. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements<sup>1/</sup> (the "auditor's unqualified report").<sup>2/</sup>
2. The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,<sup>3/</sup> in conformity with the applicable financial reporting framework.<sup>4/</sup>

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<sup>1/</sup> This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; see, e.g., Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>2/</sup> Paragraphs 85-98 and Appendix C, "Special Reporting Situations," of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

<sup>3/</sup> AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

<sup>4/</sup> The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

3. When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements. AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

### **Objectives**

4. The objectives of the auditor when the auditor concludes that an auditor's unqualified opinion is appropriate are to:
- a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and
  - b. Communicate in the auditor's unqualified report **critical audit matters**<sup>5/</sup> relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

### **The Auditor's Unqualified Report**

5. The auditor's unqualified report includes:<sup>6/</sup>
- a. The basic elements, as described in paragraph 6;
  - b. Communication of critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs 7-14; and
  - c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs 15-16.

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<sup>5/</sup> This term, as defined in Appendix A, "Definitions," is set in **boldface type** the first time it appears.

<sup>6/</sup> Appendix B provides an illustrative auditor's unqualified report.

## Basic Elements

6. The auditor must include the following basic elements in the auditor's report:<sup>7/</sup>
- a. The title, "Report of Independent Registered Public Accounting Firm";
  - b. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;<sup>8/</sup>

### *Introduction*

- c. The name of the company whose financial statements were audited;
- d. A statement identifying each financial statement and related schedule, if applicable, that has been audited;<sup>9/</sup>
- e. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;
- f. A statement indicating that the financial statements, including the related notes and, if applicable, schedules, identified and collectively referred to in the report as the financial statements, were audited;

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<sup>7/</sup> Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. See, e.g., Investment Company Act § 30(g) and § 32(a)(4); SEC Rule 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02; and Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 C.F.R. § 240.17a-5. Auditor reports on financial statements filed with the SEC are required to comply with all such applicable requirements.

<sup>8/</sup> For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

<sup>9/</sup> Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. See, e.g., SEC Rules 5-04, 6-10, 6A-05, and 7-05 of Regulation S-X, 17 C.F.R. §§ 210.5-04, 210.6-10, 210.6A-05, 210.7-05. See generally, SEC Rule 12-01 of Regulation S-X, 17 C.F.R. § 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

- g. A statement that the financial statements are the responsibility of the company's management;
- h. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB;<sup>10/</sup>
- i. A statement containing the year the auditor began serving consecutively as the company's auditor;

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

*Basis of Opinion*

- j. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;
- k. A statement that the audit was conducted in accordance with the standards of the PCAOB;
- l. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

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<sup>10/</sup> The term "United States federal securities laws" has the same meaning as "securities laws" as defined in PCAOB Rule 1001(s)(ii).

- m. A statement that an audit includes:
- (1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
  - (2) Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
  - (3) Evaluating the accounting principles used and significant estimates made by management; and
  - (4) Evaluating the overall presentation of the financial statements;
- n. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion;

*Opinion on the Financial Statements*

- o. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.<sup>11/</sup> The opinion should also include an identification of the applicable financial reporting framework;

*The Auditor's Responsibilities Regarding Other Information*

- p. When other information is included in an annual report filed with the SEC under the Exchange Act that contains both the audited financial statements and the related auditor's report, a section titled "The Auditor's Responsibilities Regarding Other Information" that includes the reporting requirements of paragraphs 13 and 14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain*

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<sup>11/</sup> The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and required financial statements. If the financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the Introduction section of the auditor's report. It need not be reported on separately in the opinion paragraph.

*Documents Containing Audited Financial Statements and the Related Auditor's Report;*<sup>12/</sup>

*Signature and Date*

- q. The signature of the auditor's firm;<sup>13/</sup>
- r. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;<sup>14/</sup> and
- s. The date of the auditor's report.<sup>15/</sup>

**Critical Audit Matters**

*Determination of Critical Audit Matters*

7. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements based on the results of the audit or evidence obtained.<sup>16/</sup>

Note: It is expected that in most audits, the auditor would determine that there are critical audit matters.

8. Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion

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<sup>12/</sup> The Auditor's Responsibilities Regarding Other Information section follows the Opinion on the Financial Statements section, any explanatory paragraphs, and the Critical Audit Matters section.

<sup>13/</sup> See SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

<sup>14/</sup> *Id.*

<sup>15/</sup> See AU sec. 530, *Dating of the Independent Auditor's Report*.

<sup>16/</sup> Auditing Standard No. 15, *Audit Evidence*, describes what constitutes evidence obtained in the audit and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.



document;<sup>17/</sup> (2) reviewed by the engagement quality reviewer;<sup>18/</sup> (3) communicated to the audit committee;<sup>19/</sup> or (4) any combination of the three.

9. Certain factors might affect whether a matter addressed during the audit of the financial statements (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. In determining whether a matter is a critical audit matter, the auditor should take into account the following factors, as well as other factors specific to the audit:

- a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
- b. The nature and extent of audit effort required to address the matter;
- c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;
- d. The severity of control deficiencies identified relevant to the matter, if any;<sup>20/</sup>
- e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;

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<sup>17/</sup> See Auditing Standard No. 3, *Audit Documentation*.

<sup>18/</sup> See Auditing Standard No. 7, *Engagement Quality Review*.

<sup>19/</sup> See Auditing Standard No. 16, *Communications with Audit Committees*, and other PCAOB standards.

<sup>20/</sup> Other PCAOB standards provide auditing and reporting requirements related to the company's internal control over financial reporting. See Auditing Standard No. 5, Auditing Standard No. 12, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*.

- f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;
- g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and
- h. The nature of consultations outside the engagement team regarding the matter, if any.

*Communication of Critical Audit Matters*

10. The auditor must communicate in the auditor's report critical audit matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

11. For each critical audit matter communicated in the auditor's report the auditor must:<sup>21/</sup>

- a. Identify the critical audit matter;
- b. Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and

Note: For example, if the auditor identified the valuation of financial instruments with little, if any, market activity at the measurement date as a critical audit matter because the valuation involved the most difficult, subjective, or complex auditor judgments, then communication of that critical audit matter in the auditor's report must describe the considerations that led the auditor to determine that the

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<sup>21/</sup> The Critical Audit Matters section follows the Opinion on the Financial Statements section and any explanatory paragraphs.

matter is a critical audit matter, which might relate to the high degree of measurement uncertainty or the significant judgments and estimates involved.

- c. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Note: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used.

*Language Preceding Critical Audit Matters in the Auditor's Report*

12. The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

*Critical Audit Matters*

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

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

13. In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most

difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. We determined that there are no critical audit matters.

#### *Documentation of Critical Audit Matters*

14. In accordance with Auditing Standard No. 3, the auditor must document the determination of critical audit matters. Auditing Standard No. 3 requires audit documentation to be prepared in such detail to provide a clear understanding of its purpose, source, and the conclusions reached.<sup>22/</sup> To provide sufficient detail for a clear understanding of the conclusions reached<sup>23/</sup> regarding the determination of critical audit matters, the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters.

Note: For example, if an audit matter was included in the engagement completion document, reviewed by the engagement quality reviewer, communicated to the audit committee and, after considering the factors in paragraph 9, otherwise would appear to an experienced auditor having no previous connection to the engagement to meet the definition of a critical audit matter, then the auditor would document the basis for the determination that the matter was not a critical audit matter.

#### **Explanatory Language Added to the Auditor's Report**

15. Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report.<sup>24/</sup> These circumstances include when:

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<sup>22/</sup> See paragraph 4 of Auditing Standard No. 3.

<sup>23/</sup> Id.

<sup>24/</sup> An explanatory paragraph follows the Opinion on the Financial Statements section, unless otherwise required by other standards of the PCAOB.

- a. There is substantial doubt about the company's ability to continue as a going concern;<sup>25/</sup>
- b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;<sup>26/</sup>
- c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;<sup>27/</sup>
- d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;<sup>28/</sup>
- e. A material misstatement in previously issued financial statements has been corrected;<sup>29/</sup>
- f. Certain circumstances relating to reports on comparative financial statements exist;<sup>30/</sup>
- g. Selected quarterly financial data required by Item 302(a) of SEC Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;<sup>31/</sup>

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<sup>25/</sup> See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

<sup>26/</sup> See paragraphs .06-.09 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

<sup>27/</sup> See paragraphs 8 and 12-15 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (as proposed to be amended by this standard).

<sup>28/</sup> See paragraph 6 of Auditing Standard No. 6.

<sup>29/</sup> See paragraphs 9 and 16-17 of Auditing Standard No. 6 (as proposed to be amended by this standard).

<sup>30/</sup> See AU secs. 508.68-.69 and .72-.74.

<sup>31/</sup> See paragraph .50 of AU sec. 722, *Interim Financial Information*.

- h. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to the requirements of the applicable financial reporting framework;<sup>32/</sup>
- i. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;<sup>33/</sup> and
- j. There has been a change in an investee year end that has a material effect on the company's financial statements.<sup>34/</sup>

16. The auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements.<sup>35/</sup> This explanatory paragraph refers only to information presented or disclosed in the financial statements. The following are examples of matters, among others, that might be emphasized in the auditor's report:<sup>36/</sup>

- a. Significant transactions with related parties;

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<sup>32/</sup> See paragraphs .03 and .08 of AU sec. 558, *Required Supplementary Information*.

<sup>33/</sup> See paragraph 88 of Auditing Standard No. 5. Auditing Standard No. 5 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, Auditing Standard No. 5 notes that the auditor should consider those circumstances as well.

<sup>34/</sup> See paragraph .32 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

<sup>35/</sup> These explanatory paragraphs follow the Opinion on the Financial Statements section in the auditor's report.

<sup>36/</sup> It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" when an explanatory paragraph to emphasize a matter regarding the financial statements is included in the auditor's report.



- b. Unusually important subsequent events, such as a catastrophe that has had, or continues to have, a significant effect on the company's financial position;
- c. 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;
- d. Retroactive application of the prospective change in accounting principle that will result in the restatement of the current year's financial statements in the future, and the effects of the prospective change are expected to be unusually material;
- e. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and
- f. That the entity is a component of a larger business enterprise.

***APPENDIX A – Definition***

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matters – Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

Note: Use of the word "most" is not intended to imply that only one matter under each criteria would qualify as a critical audit matter. Depending on the facts and circumstances of the audit, there could be several critical audit matters. Also, an audit matter could meet one, two, or all three of the criteria in the definition.

## ***APPENDIX B – An Illustrative Auditor's Unqualified Report***

[Changes from the current illustrative report are underlined]

### **Report of Independent Registered Public Accounting Firm**

To the shareholders and board of directors of X Company

#### [Introduction]

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X<sub>2</sub> and 20X<sub>1</sub>, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X<sub>2</sub>, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

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

#### [Basis of Opinion]

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

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

[Opinion on the Financial Statements]

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

Critical Audit Matters

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

[Include critical audit matters]

The Auditor's Responsibilities Regarding Other Information

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

[Signature]

[City and State or Country]

[Date]

## **APPENDIX 2**

### **Proposed Auditing Standard**

#### ***The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

##### ***Introduction***

1. This standard establishes requirements regarding the auditor's responsibilities with respect to information, other than the audited financial statements<sup>1/</sup> and the related auditor's report, in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act")<sup>2/</sup> and contains that company's audited financial statements and the related auditor's report (hereafter "other information").<sup>3/</sup>

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<sup>1/</sup> This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b).

<sup>2/</sup> This standard does not apply to documents filed under the Securities Act of 1933 ("Securities Act"). When the audited financial statements and the related auditor's report are included in a registration statement under the Securities Act, the auditor has responsibilities under the federal securities laws and under AU sec. 711, *Filings Under Federal Securities Statutes*. This standard also does not modify the auditor's responsibilities under the federal securities laws or AU sec. 711. See, e.g., Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1.

<sup>3/</sup> This standard does not apply to supplemental information addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*; required supplementary information addressed by AU sec. 558, *Required Supplementary Information*; and management's assertion on internal control over financial reporting in an integrated audit addressed by Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Note: For purposes of this standard, other information in an annual report<sup>4/</sup> that is filed with the SEC under the Exchange Act includes information, other than the audited financial statements and the related auditor's report, contained in the annual report and also includes (1) information incorporated by reference in that annual report that is available to the auditor prior to the issuance of the auditor's report and (2) when the annual report is a Form 10-K, information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.<sup>5/</sup>

## **Objectives**

2. The objectives of the auditor are:
  - a. To evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ("material inconsistency");<sup>6/</sup> (2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and
  - b. When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the

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<sup>4/</sup> With respect to a company's amended annual report that contains the company's previously issued audited financial statements and the related auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of this standard. When the company's amended annual report contains (1) revisions to amounts or disclosures in the previously issued audited financial statements and (2) a related auditor's report, the auditor would apply all paragraphs of this standard.

<sup>5/</sup> With respect to other information that is incorporated by reference into an annual report on Form 10-K from a proxy statement that is filed subsequent to the issuance of the auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of this standard.

<sup>6/</sup> The requirements of this standard related to material inconsistency apply to a predecessor auditor in situations in which the predecessor auditor's report is included in an annual report containing other information.



audit, the other information contains a material inconsistency, a material misstatement of fact, or both.

## ***Auditor's Responsibilities***

### **Evaluating the Other Information**

3. The auditor must evaluate whether the other information contains (1) a material inconsistency; (2) a material misstatement of fact; or (3) both by performing the procedures in paragraph 4.

4. The auditor should read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the:

- a. Consistency of amounts in the other information, and the manner of their presentation, that are intended to be the same as, or to provide greater detail about, the amounts in the financial statements, with the amounts in the financial statements and relevant audit evidence;
- b. Consistency of any qualitative statement in the other information, and the manner of its presentation, that is intended to represent or provide greater detail about information in the financial statements, with the financial statements and relevant audit evidence;
- c. Other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit; and
- d. Amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence, by recalculating the amounts for mathematical accuracy.

Note: For example, the auditor would recalculate the amounts when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula. Amounts, such as totals or percentages, that are calculated using simple mathematical operations, such as addition or division, ordinarily can be recalculated without referring to a formula.

5. If, based on the evaluation in paragraph 4, the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, the auditor

should discuss the matter with management. The auditor also should perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both.

**Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both**

6. If the auditor determines that the other information contains a material inconsistency, a material misstatement of fact, or both, the auditor should request management to revise the other information to address the material inconsistency, the material misstatement of fact, or both.

7. If management does not appropriately revise the other information and:

- a. The other information is available to the auditor prior to the issuance of the auditor's report, the auditor should perform the applicable procedures in paragraphs 8 and 9.
- b. The other information is not available to the auditor prior to the issuance of the auditor's report, the auditor should perform the applicable procedures in paragraphs 10 and 11.<sup>7/</sup>

*Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report*

8. If management does not appropriately revise the other information, the auditor should communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner and prior to the issuance of the auditor's report.

9. If the other information is not appropriately revised after the auditor has communicated the material inconsistency, the material misstatement of fact, or both to the audit committee, the auditor:

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<sup>7/</sup> Information incorporated by reference into a Form 10-K from the company's definitive proxy statement, filed within 120 days after the end of the fiscal year covered by the Form 10-K, might not be available to the auditor prior to the issuance of the auditor's report. Additionally, other information included in an amended annual report that contains previously issued audited financial statements and the related auditor's report, would not be available to the auditor prior to the issuance of the auditor's report.

- a. Must determine the auditor's responsibilities under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1; AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; and AU sec. 317, *Illegal Acts by Clients*; and
- b. Should determine whether to:
  - (1) Issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both; or
  - (2) Withdraw from the engagement.

Note: In addition, the auditor may withhold the use of the auditor's report for a prior reporting period.

*Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report*

10. If management does not appropriately revise the other information, the auditor should communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner.

11. If the other information is not appropriately revised after the auditor has communicated the material inconsistency, the material misstatement of fact, or both to the audit committee, the auditor:

- a. Must determine the auditor's responsibilities under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1; and
- b. Should apply the procedures in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

## **Responding When the Auditor Determines That There Is a Potential Misstatement in the Audited Financial Statements**

12. If, as a result of procedures performed under this standard, the auditor determines that there is a potential misstatement in the audited financial statements, the auditor should refer to the requirements of:

- a. Auditing Standard No. 14, *Evaluating Audit Results*, and AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, if the auditor's report on the financial statements has not been issued; or
- b. AU sec. 561 if the auditor's report on the financial statements has been issued.

## ***Reporting in the Auditor's Report***

13. When issuing an auditor's report, the auditor must include, in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information,"<sup>8/</sup> the following:

- a. A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)], in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB"), the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;
- b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;
- c. A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;

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<sup>8/</sup> This reporting requirement applies to an auditor's report other than a report to disclaim an opinion. See AU sec. 508.61.

- d. A statement that the auditor did not audit the other information and does not express an opinion on the other information; and
- e. A statement that, based on the evaluation, the auditor:
  - (1) Has not identified a material inconsistency or a material misstatement of fact in the other information;<sup>9/</sup> or
  - (2) Has identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

14. The following is an example of "The Auditor's Responsibilities Regarding Other Information" section of the auditor's report:

- a. Illustrative language for paragraphs 13.a.–d.:

*The Auditor's Responsibilities Regarding Other Information*

In addition to auditing the company's financial statements [and internal control over financial reporting (if applicable)], in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [SEC Exchange Act form type] filed with the SEC that contains both the [period end date] financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information.

- b. Illustrative language for paragraph 13.e.(1) when the auditor has not identified a material inconsistency or a material misstatement of fact in the other information:

Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

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<sup>9/</sup> This statement is appropriate in situations in which the auditor (1) has not identified a material inconsistency or a material misstatement of fact or (2) has identified a material inconsistency, a material misstatement of fact, or both that management has revised appropriately prior to the issuance of the auditor's report.

- c. Illustrative language for paragraph 13.e.(2) when the auditor has identified a material inconsistency, a material misstatement of fact, or both in the other information:

Based on our evaluation, we identified [*a material inconsistency, a material misstatement of fact, or both*] in the other information that has not been appropriately revised. [*Describe the material inconsistency, the material misstatement of fact, or both.*] We have not identified [*a material inconsistency or material misstatement of fact* (this statement would indicate the situation that was not identified in the sentence above)] in the other information.<sup>10/</sup>

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<sup>10/</sup> This sentence is appropriate only when the auditor has identified a material inconsistency or a material misstatement of fact, but not both. If the auditor identifies both a material inconsistency and a material misstatement of fact, the auditor's report should describe both the material inconsistency and the material misstatement of fact.

## **APPENDIX 3**

### ***Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard***

In connection with the proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"), the Board is proposing amendments to several of its auditing standards to conform to the requirements of the proposed auditor reporting standard.<sup>1/</sup>

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences and paragraphs is intended to assist readers in easily comprehending the Board's proposed changes to existing auditing standards and interpretations. The Board's proposed amendments consist of only the deletion or addition of the language that has been struck through or underlined. This presentation does not constitute or represent a reproposal of all or of any other part of a standard or interpretation that may be amended.

The proposed amendments would amend specific auditing standards to reflect changes to the auditor's unqualified report. Some of these auditing standards may need further updating, which the Board may consider under separate standard-setting projects. The proposed amendments in connection with the proposed auditor reporting standard would include:

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<sup>1/</sup> PCAOB Release No. 2013-002, *Proposed Reorganization of PCAOB Auditing Standards* (March 26, 2013), PCAOB Release No. 2013-004, *Related Parties* (May 7, 2013), PCAOB Release No. 2011-005, *Auditing Supplemental Information Accompanying Audited Financial Statements* (July 12, 2011), and PCAOB Release No. 2011-007, *Improving Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2* (October 11, 2011), include proposed amendments that would supersede, amend, or delete paragraphs for which amendments are included in this proposed auditor reporting standard. If, prior to the conclusion of this rulemaking, the Board has adopted amendments that affect the amendments proposed in this release, the Board may make conforming changes to this proposed auditor reporting standard.



- Changing the title of AU sec. 508 from "Reports on Audited Financial Statements" to [new proposed title] "Departures from Unqualified Opinions and Other Reporting Circumstances."
- Updating illustrative reports in AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the proposed basic elements of the proposed auditor reporting standard;
- Updating other reporting standards that result in the issuance of the auditor's report on the financial statement filed with the SEC for the proposed basic elements of the proposed auditor reporting standard;
- Updating references to "the auditor's standard report" and "introductory, scope, and opinion paragraphs" to reflect new terms referenced in the proposed auditor reporting standard;
- Updating Auditing Standards Nos. 7 and 16 and AU sec. 336 as a result of the new reporting requirement for critical audit matters in the auditor's report;
- Moving explanatory paragraph reporting examples from existing AU sec. 508 to the respective auditing standards that contain the related performance requirements for those circumstances; and
- Updating references to auditing standards that are being amended or superseded.

The Board is requesting comments on all aspects of the proposed amendments. Significant proposed amendments are described in more detail in Appendix 5 of this release.

**Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board***

\* \* \*

**APPENDIX**

**Illustrative Reports**

The following is an illustrative report on an audit of financial statements:

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]~~

The following is an illustrative report on a review of interim financial information:

Report of Independent Registered Public Accounting Firm

~~We have reviewed the accompanying [ describe the interim financial information or statements reviewed ] of X Company as of September 30, 20X3 and 20X2, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the Company's management.~~

~~We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than~~

~~an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.~~

~~Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial (statements) for it (them) to be in conformity with U.S. generally accepted accounting principles.~~

~~[Signature]~~

~~[City and State or Country]~~

~~[Date]~~

**Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***

\* \* \*

85. The auditor's report on the audit of internal control over financial reporting must include the following elements<sup>18/</sup>

- a. A The title that includes the word *independent*, "Report of Independent Registered Public Accounting Firm";
- a-1. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;<sup>18A/</sup>
  - <sup>18A/</sup> For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.
- a-2. The name of the company whose internal control over financial reporting was audited;
- a-3. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;

- a-4. A statement containing the year the auditor began serving consecutively as the company's auditor;

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

- f. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States);~~

\* \* \*

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of W Company

[ ~~Introductory paragraph~~ Introduction ]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8, and the related notes (collectively referred to as the "financial statements"). We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with

respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ year ].

~~[ Scope paragraph ]~~ [ Basis of Opinion ]

Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the company's internal control over financial reporting based on our audits. We conducted our audits in accordance with the standards of the ~~PCAOB Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence supporting regarding the amounts and disclosures in the financial statements, Our audits also included evaluating assessing the accounting principles used and significant estimates made by management, and as well as evaluating the overall financial statement presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

~~[ Definition paragraph ]~~

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or

timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[ *Inherent limitations-Limitations paragraph* ]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[ *Opinions on the Financial Statements and Internal Control Over Financial Reporting paragraph* ]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [ *Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."* ] .

#### Critical Audit Matters

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

[Include critical audit matters]

#### The Auditor's Responsibilities Regarding Other Information

In addition to auditing the financial statements and the Company's internal control over financial reporting, in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [SEC Exchange Act form type] filed with the SEC that contains both the December 31, 20X8 financial statements



and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (following the Opinion on the Financial Statements section) to the auditor's report on the financial statements -

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (~~United States~~), W Company's internal control over financial reporting as of December 31, 20X8, based on [ *identify control criteria* ] and our report dated [ *date of report, which should be the same as the date of the report on the financial statements* ] expressed [ *include nature of opinion* ].

The auditor also should add the following paragraph (following the opinion) to the report on internal control over financial reporting -

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [ *identify financial statements* ] of W Company and our report dated [ *date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting* ] expressed [ *include nature of opinion* ].

\* \* \*

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis of Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the



criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

\* \* \*

## **Auditing Standard No. 6, *Evaluating Consistency of Financial Statements***

\* \* \*

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in ~~AU sec. 508, *Reports on Audited Financial Statements*~~ proposed paragraphs 12-15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AU sec. 508.~~<sup>8A/</sup>

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) to the auditor's report, as described in ~~AU sec. 508~~ paragraphs 12-15 of this standard.

<sup>8A/</sup> AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

## **Correction of a Material Misstatement in Previously Issued Financial Statements**

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508 paragraphs 16-17 of this standard.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*, and AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

## **CHANGE IN CLASSIFICATION**

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7<sub>1</sub> and 8<sub>1</sub> and AU sec. 50812-15 of this standard. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9<sub>1</sub> and 10<sub>1</sub> and AU sec. 50816-17 of this standard.

## **REPORTING ON CONSISTENCY OF FINANCIAL STATEMENTS**

### **Change in Accounting Principle**

12. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the Opinion on the Financial Statements section. The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

13. The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [describe accounting method changes] in [year(s) of financial statements that reflect the accounting method change] due to the adoption of [name of accounting pronouncement].

14. The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [describe accounting method changes] in [year(s) of financial statements that reflect the accounting method change].

15. The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

### **Correction of a Material Misstatement in Previously Issued Financial Statements**

16. Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the Opinion on the Financial Statements section.<sup>10/</sup> The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

<sup>10/</sup> AU secs. 508.68-69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

17. This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to

correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

### **Auditing Standard No. 7, *Engagement Quality Review***

\* \* \*

10. In an audit, the engagement quality reviewer should:

\* \* \*

- j. Based on the procedures required by this standard, evaluate whether appropriate critical audit matters are communicated in the auditor's report in accordance with Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

\* \* \*

### **Auditing Standard No. 14, *Evaluating Audit Results***

\* \* \*

<sup>7/</sup> If the financial statements contain material misstatements, AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

\* \* \*

### **APPENDIX B**

<sup>1/</sup> If the financial statements contain material misstatements, AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

\* \* \*

## APPENDIX C

<sup>2/</sup> Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AU sec. 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

### **Auditing Standard No. 16, *Communications with Audit Committees***

\* \* \*

#### **~~Departure from the Auditor's Standard Report~~ The Auditor's Report**

21. The auditor should ~~communicate~~ provide to and discuss with the audit committee the following matters related to a draft of the auditor's report:

- a. ~~When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~
- b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

\* \* \*

<sup>39/</sup> See paragraphs .22-.32 of AU sec. 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, for a discussion of scope limitations.

\* \* \*

### **AU sec. 315, *Communications Between Predecessor and Successor Auditors***

\* \* \*

<sup>fn9</sup> See section 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .70 through .74, for reporting guidance.

\* \* \*

### **AU sec. 317, *Illegal Acts by Clients***

\* \* \*

<sup>fn 2</sup> See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

\* \* \*

### **AU sec. 9326, *Evidential Matter: Auditing Interpretations of Section 326***

\* \* \*

.10 The third standard of field work requires the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .24, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, section 333 on *Management Representations* requires the auditor to obtain written representations from management. Section 333.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and section 333.08 states that a materiality limit does not apply to that representation. Section 333.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

\* \* \*

### **AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***

\* \* \*

<sup>fn 15</sup> See section 508, ~~*Reports on Audited Financial Statements*~~, paragraphs .16–.18. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

\* \* \*



### **AU sec. 333, *Management Representations***

\* \* \*

<sup>fn 15</sup> See section 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .71. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

\* \* \*

### **AU sec. 336, *Using the Work of a Specialist***

\* \* \*

**.13** If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (See section 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .22 and .23.)

\* \* \*

**.15** Except as discussed in paragraphs .16 and .16A, the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

**.16** The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to ~~his or her standard~~ the auditor's unqualified report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.



.16A Reference to the use of a specialist also may be made in the auditor's report in connection with the auditor's communication of critical audit matters, if the auditor believes such reference will facilitate an understanding of the audit matter or the considerations that led the auditor to determine that the audit matter is a critical audit matter.<sup>fn 7</sup>

<sup>fn 7</sup> Critical audit matters are described in paragraphs 7-13 of the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

**AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336***

\* \* \*

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer.<sup>fn 14</sup> However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .35 through .60. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with section 508.22–.26 and 508.61–.63.

\* \* \*

**AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern***

\* \* \*

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

\* \* \*

- c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

\* \* \*

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) to reflect that conclusion.<sup>fn 4</sup> The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13. [As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

<sup>fn 4</sup> The inclusion of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see section 508, ~~Reports on Audited Financial Statements~~ [new proposed title] Departures from Unqualified Opinions and Other Reporting Circumstances, paragraphs .61-.63).

.13 An example follows of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.<sup>fn 5</sup>

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going

concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

**.14** If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in section 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

\* \* \*

**.16** If substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of prior period financial statements that are presented on a comparative basis, and that doubt has been removed in the current period, the explanatory paragraph included in the auditor's report (following the ~~opinion paragraph~~ *Opinion on the Financial Statements* section) on the financial statements of the prior period should not be repeated.

\* \* \*

**AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342***

\* \* \*

**.03 *Required Information Presented***—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an ~~emphasis-of-matter~~ *explanatory* paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (see paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

\* \* \*

**AU sec. 9410, Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410**

\* \* \*

.15 Section 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .41 states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include related notes)." For financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion as to conformity with GAAP, as required by section 508.41.

\* \* \*

.18 Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see ~~section 508.19~~ paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

\* \* \*

**AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles**

.01 An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the country of origin of those generally accepted accounting principles also is required (see ~~section 508.08~~ paragraph 6.o. of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

\* \* \*

### **AU sec. 504, *Association With Financial Statements***

\* \* \*

**.04** An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and AU section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in section 722, *Interim Financial Information*.

\* \* \*

### **AU sec. 508, ~~Reports on Audited Financial Statements~~<sup>fn\*</sup> [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances***

<sup>fn\*</sup> ~~This section has been revised to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.~~

## **INTRODUCTION**

~~**.01** This section applies to auditors' reports issued in connection with audits<sup>fn1</sup> of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

Note: ~~When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85-98 of PCAOB Auditing Standard No. 5, *An Audit of*~~

~~Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and Appendix C, Special Reporting Situations, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, for direction on reporting on internal control over financial reporting. In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, which includes an illustrative combined audit report.~~

~~<sup>fn-1</sup> An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards in effect at the time the audit is performed. Generally accepted auditing standards include the ten standards as well as the Statements on Auditing Standards that interpret those standards. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~.02 This section does not apply to unaudited financial statements as described in section 504, Association With Financial Statements, nor does it apply to reports on incomplete financial information or other special presentations as described in section 623, Special Reports.~~

~~.03 Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with generally accepted auditing standards and on the findings. Generally accepted auditing standards include four standards of reporting. This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.~~

~~.04 The fourth standard of reporting is as follows:~~

~~The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~.05 The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the fourth standard of reporting as it applies to comparative financial statements.) The auditor may express an unqualified opinion on~~



~~one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

### **~~THE AUDITOR'S STANDARD REPORT~~**

~~.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.~~

~~.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

- ~~a. A title that includes the word *independent*<sup>fn 3</sup>~~
- ~~b. A statement that the financial statements identified in the report were audited~~
- ~~c. A statement that the financial statements are the responsibility of the Company's management<sup>fn 4</sup> and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~
- ~~d. A statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards)~~
- ~~e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~



~~f. A statement that an audit includes—~~

- ~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~
- ~~(2) Assessing the accounting principles used and significant estimates made by management~~
- ~~(3) Evaluating the overall financial statement presentation<sup>fn-5</sup>~~

~~g. A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~h. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles<sup>fn-6</sup>.)~~

~~i. The manual or printed signature of the auditor's firm~~

~~j. The date<sup>fn-7</sup> of the audit report~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Independent Auditor's Report~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. 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 audit.~~

~~We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides 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 X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[Signature]~~

~~[Date]~~

~~The form of the auditor's standard report on comparative financial statements<sup>fn-8</sup> is as follows:~~

Independent Auditor's Report

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. 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 auditing standards generally accepted in the United States of America. 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 X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[Signature]~~

~~[Date]~~

~~k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~<sup>fn-3</sup> This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.~~

~~<sup>fn-4</sup> In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~<sup>fn-5</sup> Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements. [As amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]~~

~~<sup>fn-6</sup> A U.S. auditor also may be engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country. In those circumstances, the auditor should refer to the guidance in section 534, *Reporting on Financial Statements Prepared for Use in Other Countries*. [Footnote added, effective for reports issued or reissued on or after June 30, 2001 by Statement on Auditing Standards No. 93.]~~

~~<sup>fn-7</sup> For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~<sup>fn-8</sup> If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such~~

~~as "for each of the three years in the period ended [date of latest balance sheet]." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

.10 This section ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard auditor's unqualified~~ report<sup>fn8A</sup> and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

- ~~• *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. This is the opinion expressed in the standard report discussed in paragraph .08.~~
- ~~• *Explanatory language added to the auditor's standard report.* 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 generally accepted accounting principles.
- *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 generally accepted accounting principles.
- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

~~These opinions are discussed in greater detail throughout the remainder of this This section also discusses other reporting circumstances such as reports on comparative financial statements.~~

~~<sup>fn8A</sup> The Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). Paragraphs 85-89 and Appendix C of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.~~

#### **~~EXPLANATORY LANGUAGE ADDED TO THE AUDITOR'S STANDARD REPORT~~**

~~.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory <sup>fn-9</sup> paragraph (or other explanatory language) to the standard report. <sup>fn-10</sup> These circumstances include:~~

- ~~a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~
- ~~b. There is substantial doubt about the entity's ability to continue as a going concern. <sup>fn-11</sup>~~
- ~~c. There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~
- ~~d. A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~
- ~~e. Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~
- ~~f. Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See section 722, *Interim Financial Information*, paragraph .50.)~~
- ~~g. Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect~~

~~to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (See section 558, *Required Supplementary Information*, paragraph .02.)~~

~~h. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .04.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19). [As amended, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79. Revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]~~

~~<sup>fn-9</sup> Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~<sup>fn-10</sup> See footnote 3. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~<sup>fn-14</sup> Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

### **Opinion Based in Part on Report of Another Auditor**

~~.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (See section 543, *Part of Audit Performed by Other Independent Auditors*.)~~

~~.13 An example of a report indicating a division of responsibility follows:~~



Independent Auditor's Report

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. 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 did not audit the financial statements of B Company, a wholly owned subsidiary, which statements reflect total assets of \$ \_\_\_\_\_ and \$ \_\_\_\_\_ as of December 31, 20X2 and 20X1, respectively, and total revenues of \$ \_\_\_\_\_ and \$ \_\_\_\_\_ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 and the report of other auditors provide a reasonable basis for our opinion.~~

~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~\* \* \*~~

**Lack of Consistency**

~~.16 The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

- ~~a. A change in accounting principle.~~
- ~~b. An adjustment to correct a misstatement in previously issued financial statements.~~

## **Change in Accounting Principle**

~~.17A As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.<sup>fn-12</sup> A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

~~<sup>fn-12</sup> The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.~~

~~.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].~~

~~.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].~~

~~.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial~~

~~statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

~~**.17E**~~

~~If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

~~**Correction of a Material Misstatement in Previously Issued Financial Statements**~~

~~**.18A** Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.<sup>fn-13</sup> The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

~~<sup>fn-13</sup> The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior period financial statements differs from the opinion previously expressed.~~

~~**.18B** This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

~~**.18C** The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

~~**Emphasis of a Matter**~~

~~**.19** In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing~~

~~[following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are—~~

- ~~• 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.~~
- ~~• 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.~~

## DEPARTURES FROM UNQUALIFIED OPINIONS

### Qualified Opinions

\* \* \*

.20A When the auditor expresses a qualified opinion, the auditor's report must include the basic elements of the auditor's unqualified report and critical audit matters described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.<sup>fn13A</sup>

<sup>fn13A</sup> When the auditor expresses a qualified opinion, the section titled "The Auditor's Responsibilities Regarding Other Information"(described in paragraphs 13-14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*) also should include language that references the matter(s) for which the auditor has qualified the opinion.

.21 When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate explanatory "basis for departure from an unqualified opinion paragraph(s)," preceding the opinion paragraph in the Opinion on the Financial Statements section of the auditor's report. The auditor should also include, in the Opinion on the Financial Statements section ~~opinion paragraph~~, the appropriate qualifying language and a reference to the explanatory "basis for departure from an unqualified opinion paragraph." A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are

not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Note: The auditor would refer to Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter.

### Scope Limitations

**.22** The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with ~~generally accepted auditing~~ standards of the Public Company Accounting Oversight Board ("PCAOB") and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

\* \* \*

**.25** When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the auditor's report situation ~~should be described in an explanatory the basis for departure from an unqualified opinion in a paragraph preceding the opinion paragraph in the Opinion on the Financial Statements section and referred to in both the scope-Basis of Opinion and the opinion-Opinion on the Financial Statements paragraphs sections of the auditor's report.~~ It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.26** When an auditor qualifies his or her opinion because of a scope limitation, the wording in the ~~opinion-paragraph~~ Opinion on the Financial Statements section should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and,

therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Same first paragraph as the standard report Includes the same basic elements as the Introduction section of the auditor's unqualified report]

[Basis of Opinion]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. Except as discussed in the following paragraph below, we conducted our audits in accordance with auditing the standards of the PCAOB generally accepted in the (United States) of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

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

[Opinion on the Financial Statements]

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$\_\_\_\_\_ and \$\_\_\_\_\_ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of \$\_\_\_\_\_ and \$\_\_\_\_\_, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first



paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

**.34** An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Introduction]

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related notes (collectively referred to as the "financial statement"). This financial statement is the responsibility of the Company's management.

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

[Basis of Opinion]

Our responsibility is to express an opinion on this financial statement based on our audit. We conducted our audit in accordance with ~~auditing the standards generally accepted in the~~ of the PCAOB (United States) of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatements of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures includes include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement. ~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

[Opinion on the Financial Statement]

In our opinion, the ~~balance sheet~~ financial statement referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**Departure from a Generally Accepted Accounting Principle**

**.35** When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with ~~generally accepted auditing the standards~~ of the PCAOB, he or she should express a qualified (paragraphs .36 through .57) or an adverse (paragraphs .58 through .60) opinion. The basis for such opinion should be stated in the report.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

**.37** When the auditor expresses a qualified opinion, he or she should disclose in the Opinion on the Financial Statements section of the report, in a separate ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" preceding the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the ~~opinion paragraph~~ Opinion on the Financial Statements section of the report should include the appropriate qualifying language and a reference to the ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)". [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.38** The ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" that discloses the reasons for the qualified opinion should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable. <sup>fn 15</sup> If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" in the auditor's report may be shortened by referring to it. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.39** An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Same first and second paragraphs as the standard report—Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report]

[Opinion on the Financial Statements]

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America.

If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_ and \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_ and \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_ and \$\_\_\_\_\_ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_ and earnings per share would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.40** If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (preceding the opinion paragraph in the Opinion on the Financial Statements section) of the auditor's report in the circumstances illustrated in paragraph .39 might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

.42 Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Same first and second paragraphs as the standard report. Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report.]

[Opinion on the Financial Statements]

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America. In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

.44 ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report if the company's management declines to present the statement a basic financial statement (for example, a statement of cash flows for one or more periods).~~ Accordingly, in these cases, the auditor should ordinarily qualify the report in the following manner:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Introduction]

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended, and the related notes (collectively referred to as the "financial statements"). 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 audit.~~

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

~~[Same second paragraph as the standard report Includes the same basic elements as the Basis of Opinion section of the auditor's unqualified report]~~

[Opinion on the Financial Statements]

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]



[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

**.51 Departures from generally accepted accounting principles related to changes in accounting principle.** Paragraph .17A 7 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* includes ~~states~~ the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

**.52** The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Same first and second paragraphs as the standard-*Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[Opinion on the Financial Statements]

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.<sup>fn 17</sup>

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and

the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

<sup>fn17</sup> Because this paragraph included in the example presented contains all of the information required in an explanatory "basis for departure from an unqualified opinion paragraph" on consistency, a separate explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) as required by paragraphs ~~.17A through .17E of this section~~ 8 and 12-15 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

\* \* \*

.58A When the auditor expresses an adverse opinion, in addition to including the title, "Report of Independent Registered Public Accounting Firm," and the addressees, the auditor's report must include the opinion as described in paragraph .58 and the basic elements included in the following sections of the auditor's unqualified report:<sup>fn17A</sup>

- a. Introduction section;
- b. Basis of Opinion section;
- c. The Auditor's Responsibilities Regarding Other Information section;<sup>fn17B</sup>  
and
- d. Signature and Date section.

Note: Critical audit matters described in paragraphs 7-13 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, are not required in reports with adverse opinions.

<sup>fn17A</sup> Basic elements of the auditor's unqualified report are described in paragraph 6 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

<sup>fn17B</sup> When the auditor expresses an adverse opinion, the section titled "The Auditor's Responsibilities Regarding Other Information" (described in paragraphs 13-14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*) also should include language that references the matter(s) for which the auditor has issued an adverse opinion.

**.59** When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" preceding the opinion paragraph in the Opinion on the Financial Statements section of the report (a) all the substantive reasons for his or her adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.<sup>fn18</sup> If the effects are not reasonably determinable, the report should so state. <sup>fn19</sup> [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

<sup>fn19</sup> When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in paragraph ~~.1415, subsection (b), (c), (d), and (e) of this section~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

**.60** When an adverse opinion is expressed, the opinion paragraph in the Opinion on the Financial Statements section of the report should include a direct reference to a separate "basis for departure from an unqualified opinion paragraph" ~~that discloses the basis for the adverse opinion~~, as shown below:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

~~[Same first and second paragraphs as the standard]~~ Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report

[Opinion on the Financial Statements]

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased \$\_\_\_\_\_ and \$\_\_\_\_\_ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$\_\_\_\_\_ and \$\_\_\_\_\_ in excess of an amount based on the cost to the Company; and deferred income taxes of \$\_\_\_\_\_ and \$\_\_\_\_\_ have not been recorded; resulting in an increase of \$\_\_\_\_\_ and \$\_\_\_\_\_ in retained earnings and in appraisal surplus of \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of \$\_\_\_\_\_ and \$\_\_\_\_\_ have not been provided, resulting in an increase in net income of \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

**.62** A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.<sup>fn 20</sup> A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (see paragraphs .35 through .57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the ~~scope paragraph of the auditor's standard-Basis of Opinion~~ section of the auditor's unqualified report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles. [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

**.62A** When the auditor disclaims an opinion, in addition to including the title, "Report of Independent Registered Public Accounting Firm," and the addressees, the auditor's report must include the basic elements included in the following sections of the auditor's unqualified report,<sup>fn20A</sup> modified appropriately as shown in an example report in paragraph .63:

- a. Introduction section; and
- b. Signature and Date section.

Note: Critical audit matters described in paragraphs 7-13 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, are not required in reports that disclaim an opinion.

<sup>fn20A</sup> Basic elements of the auditor's unqualified report are described in paragraph 6 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

**.63** An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Introduction]

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.<sup>fn 21</sup>

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

[Second paragraph of standard report Basic elements in the Basis of Opinion section of the auditor's unqualified report should be omitted]

[Opinion on the Financial Statements]

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at \$\_\_\_\_\_ as of December 31, 20X2, and at \$\_\_\_\_\_ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature]

[City and State or Country]

[Date]

<sup>fn21</sup> The wording in the ~~first paragraph~~ Introduction section of the auditor's ~~standard unqualified~~ report is changed in a disclaimer of opinion because of a scope limitation.



The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with ~~generally accepted auditing~~ the standards of the PCAOB. ~~In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.~~ [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

\* \* \*

## REPORTS ON COMPARATIVE FINANCIAL STATEMENTS

**.65** The fourth standard of reporting<sup>fn21A</sup> requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor<sup>fn22</sup> should update<sup>fn23</sup> the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.<sup>fn24</sup> Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .01.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

<sup>fn21A</sup> See paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*.

\* \* \*

## Different Reports on Comparative Financial Statements Presented

**.67** Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements (~~excluding the standard introductory and scope paragraphs, where applicable~~) with different reports on one or more financial statements presented.

**~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Same first and second paragraphs as the standard Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report]

[Opinion on the Financial Statements]

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, for the year then ended.

In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

**~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows**

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Same first paragraph as the standard Includes the same basic elements as the Introduction section of the auditor's unqualified report]

[Basis of Opinion]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. Except as explained in the following first paragraph in the Opinion on the Financial Statements section, we conducted our audits in accordance with auditing the standards generally accepted in the of the PCAOB (United States) of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

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

[Opinion on the Financial Statements]

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.<sup>fn 25</sup>

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of ABC Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

**.69** If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph(s) preceding the opinion paragraph in the Opinion on the Financial Statements section of his or her report.<sup>[fn 29]</sup> The ~~explanatory~~ paragraph(s) should disclose (a) the date of the auditor's previous report, (b) the type of opinion previously expressed, (c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (d) the circumstances or events that caused the auditor to express a different opinion, and (e) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (f) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of an ~~explanatory~~ paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

~~Independent Auditor's Report of Independent Registered Public Accounting Firm~~

~~To the shareholders and board of directors of X Company~~

~~[Same first and second paragraphs as the standard Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report]~~

[Opinion on the Financial Statements]

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its

property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report.<sup>fn 26</sup>

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

\* \* \*

.74 If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph Basis of Opinion section of his or her report (a) that the financial statements of the prior period were audited by another auditor,<sup>fn 29</sup> (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than a ~~standard~~ an auditor's unqualified report, the substantive reasons therefor.<sup>fn 30</sup> An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for

the year then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

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

[Basis of Opinion]

Our responsibility is to express an opinion on ~~these~~ the Company's financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements. We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

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

[Same second paragraph as the standard report *Opinion on the Financial Statements*]

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]



[City and State or Country]

[Date]

If the predecessor auditor's report was other than a ~~standard~~ an auditor's unqualified report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

. . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Basis of Opinion section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

~~[Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]~~

\* \* \*

**AU sec. 9508, Reports on Audited Financial Statements [new proposed title] Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of Section 508**

\* \* \*

**.01 Question**—Section 508, ~~Reports on Audited Financial Statements~~ [new proposed title] Departures from Unqualified Opinions and Other Reporting Circumstances, paragraph .24 states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the

auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

\* \* \*

~~.36 Examples of An example of the Introduction and the Opinion on the Financial Statements sections of an auditor's reports on single year financial statements in the year of adoption of liquidation basis follows.<sup>fn 1A</sup> with such an explanatory paragraph follow.~~

~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~

~~[Introduction]~~

~~"We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes (collectively referred to as the "financial statements"). 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 audit.~~

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

~~"We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides a reasonable basis for our opinion.~~

[Opinion on the Financial Statements]

"As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph."

<sup>fn1A</sup> The auditor's report must include other basic elements of the auditor's unqualified report and critical audit matters described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*  
An example of the Introduction and the Opinion on the Financial Statements sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows:<sup>fn1B</sup>

[Introduction]

~~"We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes (collectively referred to as the "financial statements"). In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

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

~~"We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. 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.~~

[Opinion on the Financial Statements]

"As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph."

<sup>fn1B</sup> Id.

\* \* \*

**12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report**

**.51 Question**—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its

responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

**.52 Interpretation**—No. The statement about management's responsibilities for the financial statements required by ~~section 508, *Reports on Audited Financial Statements*~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard unqualified~~ report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

\* \* \*

**14. Reporting on Audits Conducted in Accordance With the Standards of the PCAOB (United States) Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing**

**.56 Question**— ~~Section 508, *Reports on Audited Financial Statements*~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, ~~requires~~ states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards. If the auditor conducts the audit in accordance with the standards of the PCAOB generally accepted in the United States of America and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board Practices Committee of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

**.57 Interpretation**—Yes. ~~Section 508~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with generally accepted auditing the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards; however, ~~section 508~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in



accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.<sup>fn4</sup>

~~fn4 Appendix B, *Analysis of International Standards on Auditing*, identifies sections and paragraphs, if applicable, within the International Standards on Auditing that may require procedures and documentation in addition to those required by U.S. auditing standards.~~

~~.58 When reporting on an audit performed in accordance with the standards of the PCAOB auditing standards generally accepted in the United States of America and International Standards on Auditing, the auditor should comply with the standards of the PCAOB reporting standards generally accepted in the United States of America.~~

~~.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB auditing standards generally accepted in the United States and in accordance with International Standards on Auditing follows:~~

[Basis of Opinion]

~~Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.~~

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

\* \* \*

~~.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to section 508, *Reports on Audited Financial Statements* [new proposed title]~~



Departures from Unqualified Opinions and Other Reporting Circumstances, paragraph .74, the successor auditor should indicate in the ~~introductory paragraph~~ Introduction section of his or her report (a) that the financial statements of the prior period were audited by another auditor, (b) the date of the predecessor auditor's report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than a ~~standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 29 of section 508 indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Basis of Opinion section of the successor auditor's report is presented as follows:

The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor's report.

\* \* \*

.78 AU sec. Section 508.42 provides an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate), ~~as follows:~~

Independent Auditor's Report

~~[Same first and second paragraphs as the standard report]~~

The Company's financial statements do not disclose ~~[describe the nature of the omitted disclosures]~~. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

\* \* \*

**.83** Following is an illustration of a ~~report that expresses a~~ qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of the Guide:

~~Independent Auditor's Report~~

~~[Same first and second paragraphs as the standard report Opinion on the Financial Statements section]~~

The Schedule of Investments included in the Partnership's financial statements does not disclose required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value \$3,280,000 (Consumer nondurable goods)
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, \$4.5 million par value—fair value \$4,875,000 (Aviation)

In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, ...

**.84** An illustration of an adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information follows.<sup>fn 6</sup> This illustration assumes that the auditor has concluded that it is not practicable to present all of the required information. In such circumstances, the auditor presents in his or her report the missing information, where it is practicable to do so, and describes the nature of the missing information where it is not practicable to present the information in the report:

~~Independent Auditor's Report~~

~~[Same first and second paragraphs as the standard report Opinion on the Financial Statements section]~~

The Partnership has declined to prepare and present a Schedule of Investments and the related information as of December 31, 20X2. Accounting principles generally accepted in the United States of America require presentation of this Schedule and the related information. Presentation of this Schedule would have disclosed required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value \$3,280,000 (Consumer nondurable goods) <sup>fn 7</sup>
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, \$4.5 million par value—fair value \$4,875,000 (Aviation)

In addition, presentation of the Schedule of Investments would have disclosed [*describe the nature of the information that it is not practicable to present in the auditor's report*].

In our opinion, because the omission of a Schedule of Investments results in an incomplete presentation as explained in the preceding paragraph, the financial statements and financial highlights referred to above do not present fairly, ...

**AU sec. 543, Part of the Audit Performed by Other Independent Auditors**

\* \* \*

**.07** When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ the Introduction, Basis of Opinion, and Opinion on Financial Statements sections the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor. <sup>fn 3</sup>

\* \* \*

**.09** An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

Independent Auditor's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Introduction]

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20...., and the related consolidated statements of income and retained earnings and cash flows for the year then ended, and the related notes (collectively referred to as the "financial statements"). 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 did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

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

[Basis of Opinion]

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

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

[Opinion on the Financial Statements]

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the

financial position of X Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Critical Audit Matters

The Auditor's Responsibilities Regarding Other Information

[Signature]

[City and State or Country]

[Date]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate. ~~[Revised, April 1998, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

**Procedures Applicable to Both Methods of Reporting**

.10 Whether or not the principal auditor decides to make reference to the audit of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:

\* \* \*

- c. Ascertain through communication with the other auditor:

\* \* \*

(ii) That he or she is familiar with accounting principles generally accepted in the United States of America and with the ~~generally accepted auditing standards~~ of the Public Company Accounting Oversight Board promulgated by the American Institute of Certified Public Accountants and will conduct his or her audit and will report in accordance therewith.

\* \* \*

\* \* \*

### **Other Auditor's Report Departs From ~~Standard~~ Auditor's Unqualified Report**

.15 If the report of the other auditor is other than a ~~standard~~ an auditor's unqualified report, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

\* \* \*

### **AU sec. 544, *Lack of Conformity with Generally Accepted Accounting Principles***

\* \* \*

.04 When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph), modified~~ modify the auditor's report as appropriate (see section 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .35 through .60 ~~.35-.60~~) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting. [As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989. As amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77.]



**AU sec. 551, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents**

\* \* \*

**.02** The auditor's ~~standard~~ unqualified report covers the basic financial statements: balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of cash flows. The following presentations are considered part of the basic financial statements: descriptions of accounting policies, notes to financial statements, and schedules and explanatory material that are identified as being part of the basic financial statements. For purposes of this section, basic financial statements also include an individual basic financial statement, such as a balance sheet or statement of income and financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

\* \* \*

<sup>fn 4</sup>See paragraph .10 for guidance when there is a modification of the auditor's ~~standard~~ unqualified report on the basic financial statements.

\* \* \*

**.10** The auditor should consider the effect of a departure ~~any modifications in his standard~~ from the auditor's unqualified report when reporting on accompanying information. When the auditor expresses a qualified opinion on the basic financial statements, he should make clear the effects upon any accompanying information as well (see paragraph .14). When the auditor expresses an adverse opinion, or disclaims an opinion, on the basic financial statements, he should not express the opinion described in paragraph .06 on any accompanying information. <sup>fn 5</sup> An expression of such an opinion in these circumstances would be inappropriate because, like a piecemeal opinion, it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements. (See section 508.64 and section 623.14.)

\* \* \*

**.21** The auditor may be requested to describe the procedures applied to specific items in the financial statements. Additional comments of this nature should not contradict or detract from the description of the scope of his audit in the ~~standard~~ auditor's unqualified report. Also, they should be set forth separately rather than interspersed with the information accompanying the basic financial statements to maintain a clear distinction between management's representations and the auditor's representations. [Paragraph

renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

\* \* \*

**AU sec. 552, Reporting on Condensed Financial Statement and Selected Financial Data**

\* \* \*

**.02** In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in section 508, ~~Reports on Audited Financial Statements~~ [new proposed title] Departures from Unqualified Opinions and Other Reporting Circumstances, paragraphs .41 through .44, section 623, *Special Reports*, or other applicable Statements on Auditing Standards.<sup>fn 2</sup>

\* \* \*

**.06** The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(a) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

**.07** A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to

report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency),<sup>fn-6</sup> the auditor should request that the client either (a) not include the auditor's name in the document or (b), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.<sup>fn 7</sup>

~~fn-6 If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (See section 508, *Reports on Audited Financial Statements*, paragraphs .41 through .44.) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Independent Auditor's Report. We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the~~

~~preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended. [Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

\* \* \*

.10 The following is an example of an additional paragraph included after the opinion paragraph in the Opinion on the Financial Statements section of the an auditor's report that includes an additional paragraph because he the auditor is also engaged to report on selected financial data for a five-year period ended December 31, 1920X5, in a client-prepared document that includes audited financial statements:

#### Independent Auditor's Report

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. 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 audit.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 provided a reasonable basis for our opinion.~~

#### Opinion on the Financial Statements

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the ABC Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with auditing the standards generally accepted in the of the PCAOB (United States) of America, the consolidated balance

sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1, and the related notes (collectively referred to as the "financial statements") (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

~~[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

\* \* \*

### **AU sec. 560, *Subsequent Events***

\* \* \*

**.09** Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his or her report an explanatory paragraph directing the reader's attention to the event and its effects. (See ~~section 508.19~~paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*)

\* \* \*

### **AU sec. 623, *Special Reports***

**.01** This section applies to auditors' reports issued in connection with the following:

\* \* \*

Note: If any of the auditor's reports described in this section are filed with the U.S. Securities and Exchange Commission, the auditor's report is required to include the basic elements of the auditor's unqualified opinion and critical audit matters as described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.* For qualified, adverse, and disclaimer of opinion reports, see requirements of AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances.*

\* \* \*

<sup>fn 2</sup> In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

\* \* \*

**.06** Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report—use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08) modified as appropriate because of the departures from generally accepted accounting principles (see AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*).

\* \* \*

**.14** The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see section 508, *Reports on Audited Financial Statements* [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .64). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**.15** When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

\* \* \*

b. A paragraph that—



(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

\* \* \*

\* \* \*

**.17** The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in ~~section 508, *Reports on Audited Financial Statements*~~, paragraph ~~4.15~~ of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

\* \* \*

**.21** When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph following the Opinion on the Financial Statements section~~, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

\* \* \*

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

- a. *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,<sup>fn 35</sup> the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon<sup>fn 36</sup> if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~section 508, *Reports on Audited Financial Statements*, paragraphs .16 through .18~~Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.<sup>[fns 37–38]</sup>
- b. \* \* \*
- c. *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in section ~~508~~543, *Reports on Audited Financial Statements—Part of Audit Performed by Other Independent Auditors*, paragraphs .12 and .13~~06–.09~~.
- d. *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in section 508, ~~*Reports on Audited Financial Statements*~~[new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .68 and .69.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof). [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

\* \* \*

<sup>fn 22</sup> When the auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the last two paragraphs of this report are examples of the paragraphs that should follow the ~~opinion paragraph~~ Opinion on the Financial Statements section of the auditor's report on the financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

\* \* \*

**AU sec. 9623, *Special Reports: Auditing Interpretations of Section 623***

\* \* \*

**.45 Interpretation**—~~Section 420.06~~ Auditing Standard No. 6, *Evaluating Consistency in Financial Statements* states that changes in accounting principles and methods of applying them affect consistency and require the addition of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's unqualified report on the audited financial statements. Section 623.16 states that, if applicable, any departures from the auditor's ~~standard-unqualified~~ report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

\* \* \*

<sup>fn 10</sup> Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AU section 508, *Reports on Audited Financial Statements*—~~[new proposed title]~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and the applicable industry audit guide.

\* \* \*

**.83 Interpretation**—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in section 508, *Reports on Audited Financial Statements*—~~[new proposed title]~~ *Departures from Unqualified Opinions and*

Other Reporting Circumstances, paragraphs .35–.44 and .58–.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

\* \* \*

**AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties***

\* \* \*

**.27** When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements, ~~for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report~~, the accountants should refer <sup>fn 18</sup> to that fact in the comfort letter and discuss the subject matter of the paragraph. <sup>fn 19</sup> In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (See also paragraph .35f.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

\* \* \*

**.30** An underwriter may also request that the accountants comment in their comfort letter on (a) unaudited interim financial information required by item 302(a) of Regulation S-K, to which section 722 pertains or (b) required supplementary information, to which section 558, *Required Supplementary Information*, pertains. Section 722 and section 558 provide that the accountants should expand the ~~standard auditor's unqualified~~ report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ auditor's unqualified report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (see also paragraph .35f). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by sections 722 and 558, the accountants may do so and report their findings. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

\* \* \*

.35 Comments included in the letter will often concern (a) unaudited condensed interim financial information (see paragraphs .36 through .38), <sup>fn 27</sup> (b) capsule financial information (see paragraphs .36 and .39 through .41), (c) pro forma financial information (see paragraphs .42 and .43), (d) financial forecasts (see paragraphs .36 and .44), and (e) changes in capital stock, increases in long-term debt, and decreases in other specified financial statement items (see paragraphs .36 and .45 through .53). For commenting on these matters, the following guidance is important:

\* \* \*

- f. When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ unqualified report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

\* \* \*

### **AU sec. 722, *Interim Financial Information***

\* \* \*

#### **Form of Accountant's Review Report**

.37 The accountant's review report accompanying interim financial information should consist of:

- a. ~~A The title that includes the word *independent*, "Report of Independent Registered Public Accounting Firm".~~

a-1. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body.<sup>fn24A</sup>

a-2. The name of the company whose interim financial information was reviewed.

a-3. The date of, or period covered by, the interim financial information and each related schedule, if applicable, identified in the report.

\* \* \*

d. A statement that the review of interim financial information was conducted in accordance with the standards established by the AICPA of the Public Company Accounting Oversight Board ("PCAOB") (United States).

e. \* \* \*

f. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing the standards of the PCAOB~~, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

g. \* \* \*

h. \* \* \*

h-1. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.

\* \* \*

In addition, each page of the interim financial information should be clearly marked as unaudited.

<sup>fn24A</sup> For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

.38 The following is an example of a review report:<sup>fn 26</sup>

Independent Accountant's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of ABC Company



We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") (United States) ~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the generally accepted auditing standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[City and State or Country]

[Date]

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q.<sup>fn 27</sup>

Independent Accountant's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of ABC Company

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB")~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with ~~auditing the standards generally accepted in the~~ of the PCAOB United States of America, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended, and the related notes (collectively referred to as the "consolidated financial statements") (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived. <sup>fn 28</sup>

[Signature]

[City and State or Country]

[Date]

**.40** The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review. <sup>fn 29</sup> The following is an example of report including such a reference:

Independent Accountant's Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of ABC Company

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These)

interim financial information (statements) is (are) the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") ~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[City and State or Country]

[Date]

**.41** The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles, <sup>fn-30</sup> which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. See paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~fn 30 If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in section 508, *Reports on Audited Financial Statements*, paragraph .15).~~

\* \* \*

**.50** The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

\* \* \*

- d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The following is an example of a paragraph that should be added to the auditor's report if the selected quarterly financial data required by item 302(a) has not been reviewed.

The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards established by the American Institute of Certified Public Accountants of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

\* \* \*

## **APPENDIX 4**

### ***Proposed Amendments to PCAOB Standards Related to the Proposed Other Information Standard***

In connection with its proposed auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"), the Board is proposing amendments to several of its auditing standards to conform to the requirements of the proposed other information standard.<sup>1/</sup>

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences and paragraphs is intended to assist readers in easily comprehending the Board's proposed changes to existing auditing standards and interpretations. The Board's proposed amendments consist of only the deletion or addition of the language that has been struck through or underlined. This presentation does not constitute or represent a reproposal of all or of any other part of a standard or interpretation that may be amended.

The proposed amendments would amend specific auditing standards to reflect requirements of the proposed other information standard. Some of these auditing standards may need further updating, which the Board may consider under separate standard-setting projects. The proposed amendments in connection with the proposed other information standard primarily include updating references to auditing standards that are being amended or superseded, changing references to AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, applied by analogy, and moving the reporting example from AU sec. 9550, *Other Information in Certain Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*, to AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, related to considerations in the auditor's report

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<sup>1/</sup> PCAOB Release No. 2013-002, *Proposed Reorganization of PCAOB Auditing Standards* (March 26, 2013), and PCAOB Release No. 2011-005, *Auditing Supplemental Information Accompanying Audited Financial Statements* (July 12, 2011), include proposed amendments that would supersede, amend, or delete paragraphs for which amendments are included in this proposed other information standard. If, prior to the conclusion of this rulemaking, the Board has adopted amendments that affect the amendments proposed in this release, the Board may make conforming changes to this proposed other information standard.

regarding a report by management on an audit of internal control over financial reporting.

The following standard and interpretation would be superseded by this proposal:

- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, and
- AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*.

The Board is requesting comments on all aspects of the proposed amendments. Significant proposed amendments are described in more detail in Appendix 6 of this release.

### **Auditing Standard No. 7, *Engagement Quality Review***

\* \* \*

<sup>5/</sup> See paragraphs ~~.04-.06~~ of AU sec. ~~550~~ Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, AU sec. 711, *Filings Under Federal Securities Statutes*.

\* \* \*

### **Auditing Standard No. 16, *Communications with Audit Committees***

\* \* \*

<sup>27/</sup> See, e.g., AU sec. ~~550~~ Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* ("proposed other information standard"). In addition to AU sec. ~~550~~ the proposed other information standard, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information*, and AU sec. 711, *Filings Under Federal Securities Statutes*.

\* \* \*

## **APPENDIX B**

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.



\* \* \*

- ~~AU sec. 550~~ Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, paragraphs ~~04 and 068~~ and 10.

\* \* \*

**AU sec. 9324, Service Organizations: Auditing Interpretations of Section 324**

\* \* \*

.37 If the service organization includes information about the design deficiencies in the section of the document titled "Other Information Provided by the Service Organization," the service auditor should read the information and ~~consider applying by analogy the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements*~~. In addition, the service auditor should include a paragraph in his or her report disclaiming an opinion on the information provided by the service organization. The following is an example of such a paragraph.

The information in section 4 describing XYZ Service Organization's plans to modify its disaster recovery plan is presented by the Service Organization to provide additional information and is not a part of the Service Organization's description of controls that may be relevant to a user organization's internal control. Such information has not been subjected to the procedures applied in the examination of the description of the controls applicable to the processing of transactions for user organizations and, accordingly, we express no opinion on it.

A service auditor also may consider communicating information about the design deficiencies in the section of the service auditor's document titled "Other Information Provided by the Service Auditor."

\* \* \*

**AU sec. 9342, Auditing Accounting Estimates: Auditing Interpretations of Section 342**

\* \* \*

**.09** When the unaudited voluntary disclosures are included in a client-prepared document and are located on the face of the financial statements, the footnotes, or in a supplemental schedule, the voluntary disclosures should be ~~labelled~~ labeled "unaudited." When such unaudited information is not presented on the face of the financial statements, the footnotes, or in a supplemental schedule, the auditor should consider the ~~guidance~~ auditor's responsibilities in ~~section 550~~ Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.*

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**AU sec. 508, Reports on Audited Financial Statements**

\* \* \*

**CONSIDERATIONS IN THE AUDITOR'S REPORT REGARDING REPORT BY MANAGEMENT ON AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING**

**.74A** In situations in which the company has determined that it is not required to obtain, nor did the company request the auditor to perform, an audit of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in annual reports filed with the SEC under the Securities Exchange Act of 1934 that contain audited financial statements and the related auditor's report in Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.*

**.74B** If the auditor has not been engaged to examine and report on management's assertion about the effectiveness of the company's internal control over financial reporting, the auditor may include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;
- The audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the

circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and

- The auditor expresses no such opinion.

Following is an example of the Basis of Opinion section in the auditor's report that contains such statements:

[Basis of Opinion]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

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

\* \* \*

***AU sec. 551, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents***

\* \* \*

**.04** When an auditor submits a document containing audited financial statements to his client or to others, he has a responsibility to report on all the information included in the document. On the other hand, when the auditor's report is included in a client-prepared document <sup>fn 2</sup> and the auditor is not engaged to report on information accompanying the

basic financial statements, his responsibility with respect to such information is described in (a) ~~section 550~~ Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and (b) other sections covering particular types of information or circumstances, such as section 558, *Required Supplementary Information*.

\* \* \*

### **AU sec. 558, *Required Supplementary Information***

\* \* \*

<sup>fn2</sup> This section is not applicable to entities that voluntarily present supplementary information not required by GAAP. For example, entities that voluntarily present supplementary information on the effects of inflation and changes in specific prices, formerly required by FASB Statement No. 33, *Financial Reporting and Changing Prices*, are guided by ~~section 550~~ Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

\* \* \*

**.03** Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph in his report on the audited financial statements a disclaimer on the information. <sup>fn3</sup>The following is an example of a disclaimer an auditor might use in these circumstances:

The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

When the auditor does not apply the procedures described in this section to a voluntary presentation of required supplementary information required for other

entities, the provisions of ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, apply, only if the annual report containing the financial statements and the related auditor's report is an annual report filed with the SEC under the Securities Exchange Act of 1934.

\* \* \*

**.05** The auditor's responsibility for other information not required by the FASB, GASB, or FASAB but included in certain annual reports—which are client-prepared documents<sup>fn4</sup>—~~is specified in section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in section 551. The auditor's responsibility for supplementary information required by the FASB, GASB or FASAB (called *required supplementary information*) is discussed in the paragraphs that follow. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

\* \* \*

**.09** In conjunction with the audit of the financial statements, the auditor may subject the supplementary information to certain auditing procedures. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the ~~audit~~auditor's report to express such an opinion, in accordance with section 550.07. [Paragraph added, effective September 2002, by Statement on Auditing Standards No. 98.]~~In those circumstances, the auditor's report should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking regarding the supplementary information. The auditor may report on the supplementary information using the following examples:~~

- a. Required supplementary information to which no qualification in the auditor's report on the financial statements applies:

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The [identify the required supplementary information] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

b. Required supplementary information to which a qualification in the auditor's report on the financial statements applies:

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The required supplementary information included in [Schedules 1 and 2] on page(s) [XX and XX] as of December 31, 19XX, is presented for purposes of additional analysis and is not a required part of the financial statements. The required supplementary information in such schedules has been subjected to the auditing procedures applied in the audit of the financial statements; and, in our opinion, except for [describe reason for qualification], such information is fairly stated in all material respects in relation to the financial statements taken as a whole.

\* \* \*

**AU sec. 9634, Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of Section 634**

\* \* \*

**.04** ~~The auditor may affirm to the board of directors that under generally accepted auditing standards, the auditor is required to read the information in addition to audited~~ auditing the financial statements contained in the Form 10-K, the auditor is required to for the purpose of considering evaluate whether such the other information included in such annual reports filed with the SEC under the Securities Exchange Act of 1934 and contain audited financial statements and the related auditor's report contains (1) a material inconsistency, (2) a material misstatement of fact, (3) or both, and, if so, to respond appropriately, and to communicate in the auditor's report whether the other information contains a material inconsistency, a material misstatement of fact, or both (see Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*). ~~may be materially inconsistent with information appearing in the financial statements (see section 550). However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.~~

\* \* \*



**AU sec. 722, *Interim Financial Information***

\* \* \*

**.18 *Inquiries and other review procedures.*** The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

\* \* \*

- f. Reading other information that accompanies the interim financial information and is contained in reports (1) to holders of securities or beneficial interests or (2) filed with regulatory authorities under the Securities Exchange Act of 1934 (such as Form 10-Q or 10-QSB), to consider whether such information or the manner of its presentation is materially inconsistent with the interim financial information or there is a material misstatement of fact in the other information.<sup>fn 12</sup> ~~If the accountant concludes that there is a material inconsistency; or becomes aware of information that he or she believes is a material misstatement of fact, the action taken will depend on his or her judgment in the particular circumstances. In determining the appropriate course of action, the accountant should consider the guidance requirements of in section 550 Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.* paragraphs .04 through .06)~~

\* \* \*

\* \* \*

## **APPENDIX 5**

### ***Additional Discussion of the Proposed Auditor Reporting Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release***

This Appendix discusses the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"), presented in Appendix 1, and the related proposed amendments to certain PCAOB auditing standards (the "proposed amendments"), presented in Appendix 3. This Appendix collectively refers to the proposed auditor reporting standard and proposed amendments as the "proposed auditor reporting standard and amendments."

Following the Board's initial outreach from October 2010 to March 2011,<sup>1/</sup> the Board issued on June 21, 2011 a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").<sup>2/</sup> Additionally, the Board held a public roundtable<sup>3/</sup> on the concept release and changing the auditor's report was discussed at the Board's Investor Advisory Group ("IAG")<sup>4/</sup> and Standing Advisory Group ("SAG") meetings.<sup>5/</sup>

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<sup>1/</sup> See Section II., *Board Outreach*, of the Release for further discussion regarding the Board's outreach.

<sup>2/</sup> *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-003 (June 21, 2011), is available at [http://pcaobus.org/Rules/Rulemaking/Docket034/Concept\\_Release.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf).

<sup>3/</sup> A transcript of the public roundtable discussions is available at [http://pcaobus.org/Rules/Rulemaking/Docket034/09152011\\_Roundtable\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf).

<sup>4/</sup> IAG meeting details and webcasts for March 2011 and 2012 are available at [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx) and [http://pcaobus.org/News/Webcasts/Pages/03282012\\_IAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/03282012_IAGMeeting.aspx).

<sup>5/</sup> See SAG meeting transcripts for November 2011 and 2012, available at [http://pcaobus.org/Rules/Rulemaking/Docket034/11102011\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf), [http://pcaobus.org/Rules/Rulemaking/Docket034/11162012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf), and [http://pcaobus.org/Rules/Rulemaking/Docket034/11152012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf).

This Appendix discusses significant comments received during the Board's outreach regarding the auditor's reporting model and also provides additional background information regarding the requirements in the proposed auditor reporting standard and amendments.

The Board requests comments on specific questions included in this Appendix as well as on its proposal in general. Additionally, to assist the Board in evaluating the clarity of the Board's proposal relating to the communication of "critical audit matters,"<sup>6/</sup> the Board requests that commenters prepare and forward to the Board for its consideration examples of critical audit matters that could be communicated in the auditor's report under the proposed auditor reporting standard.<sup>7/</sup>

Further, the Board is seeking comment on economic considerations related to the proposed auditor reporting standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters. Commenters providing cost estimates are requested to provide the basis for any estimate provided. Finally, the Board is seeking comment on the applicability of the proposed auditor reporting standard and amendments to specific entities, including the audits of brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans. Considerations related to the applicability of the proposed auditor reporting standard and amendments to audits of emerging growth companies ("EGCs") are discussed in Appendix 7.

The following sections describe the requirements in the proposed auditor reporting standard and amendments. The Exhibit to this Appendix provides three illustrative examples of communications of critical audit matters.

**I. Introduction (Paragraphs 1 – 3 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard establishes requirements for the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted

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<sup>6/</sup> See Section V., *Critical Audit Matters*, of this Appendix for discussion of the proposed critical audit matters.

<sup>7/</sup> Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

an audit in accordance with the standards of the PCAOB and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

The proposed auditor reporting standard would supersede portions of existing AU sec. 508, *Reports on Audited Financial Statements*, ("existing AU sec. 508") that primarily relate to an unqualified opinion.<sup>8/</sup> When the auditor is unable to express an unqualified opinion on the financial statements, resulting from, for example, a scope limitation or from the financial statements containing a material departure from the applicable financial reporting framework, the auditor would continue to refer to the requirements in existing AU sec. 508. Existing AU sec. 508 would be retitled to "Departures from Unqualified Opinions and Other Reporting Circumstances" and also would include proposed amendments resulting from issuance of the proposed auditor reporting standard.<sup>9/</sup>

## **II. Objectives (Paragraph 4 of the Proposed Auditor Reporting Standard)**

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed auditor reporting standard to highlight the overall context for the requirements of the standard. The proposed auditor reporting standard states that when the auditor concludes that an auditor's unqualified opinion is appropriate, the objectives of the auditor are to:

- Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and
- Communicate in the auditor's unqualified report critical audit matters relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

The Board's existing AU sec. 508 does not include an objective for the auditor when expressing an opinion on the financial statements. However, existing AU sec. 508 states that the report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed, and, where an auditor's name is associated with financial

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<sup>8/</sup> AU secs. 508.01-.09 and .11-.19 would be superseded.

<sup>9/</sup> See Section VII., *Amendments to Other PCAOB Standards*, for a discussion of how the requirements of the proposed auditor reporting standard relate to a qualified opinion, adverse opinion, and disclaimer of opinion.

statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.<sup>10/</sup> The objectives of the proposed auditor reporting standard include the auditor's expression of the opinion on the financial statements. Additionally, the basic elements that describe the nature of the audit and the auditor's responsibilities are similar to an indication of the character of the auditor's work.<sup>11/</sup>

Question Related to Section II:

1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?

**III. The Auditor's Unqualified Report (Paragraph 5 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard provides the overall framework for the auditor's unqualified report. This framework would include:

- Basic elements;
- Communication of critical audit matters; and
- Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances.

Because of changes being proposed to the auditor's report, the proposed auditor reporting standard uses the term "auditor's unqualified report" to differentiate it from the "auditor's standard report" described in existing AU sec. 508. The auditor's unqualified report, as described in the proposed auditor reporting standard, not only would include certain standardized language but also would include tailored language related to the auditor's communication of critical audit matters specific to the individual audit.

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<sup>10/</sup> See existing AU sec. 508.04.

<sup>11/</sup> See Section IV., *Basic Elements*, of this Appendix for discussion of the proposed basic elements.

#### **IV. Basic Elements (Paragraph 6 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard retains the basic elements from existing auditor reporting standards<sup>12/</sup> and incorporates elements from existing illustrative reports that accompany the existing auditor reporting standards. Additionally, the proposed auditor reporting standard improves the language for certain elements in the existing auditor reporting standards. Finally, the proposed auditor reporting standard adds new elements that provide more information about the audit and the auditor, such as information regarding auditor tenure and the auditor's responsibilities regarding other information outside the audited financial statements and the results of the auditor's evaluation of the other information.

The proposed auditor reporting standard retains the pass/fail model of the existing auditor's report. Many commenters supported retaining the pass/fail model because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented. Additionally, commenters indicated support for the concise and useful message of the pass/fail model.

The proposed basic elements are intended to improve investors' and other financial statement users' understanding about the auditor, the nature of an audit, and the auditor's responsibilities. Except for the new proposed requirement regarding the auditor's responsibilities for other information outside the financial statements, the proposed changes to the basic elements do not represent a significant departure from existing requirements and the Board does not anticipate that they would impose significant additional costs.<sup>13/</sup> The Board, however, would expect audit firms to incur minimal one-time costs that relate primarily to updating a firm's methodology regarding auditor reporting. These changes might not result in significant recurring costs because they involve standardized language that, once implemented, would be the same or very similar across different auditors' reports.

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<sup>12/</sup> See AU sec. 508 and Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board*.

<sup>13/</sup> Costs related to reporting regarding the auditor's responsibilities for other information outside the financial statements and the results of the auditor's evaluation of the other information are discussed in Appendix 6.



**A. Basic Elements Retained from Existing Standards and Incorporated from Existing Illustrative Reports**

*1. Basic Elements Retained from Existing Standards*

The proposed auditor reporting standard retains the existing basic elements that are currently included in the auditor's report. Commenters indicated that these elements remain important for an understanding of the audit and the auditor's opinion and provide consistency and comparability among auditors' reports.

The basic elements retained from the existing auditor reporting standards include:

- A statement identifying each financial statement and related schedule, if applicable, that has been audited (paragraph 6.d. of the proposed auditor reporting standard);
- A statement that the financial statements are the responsibility of the company's management (paragraph 6.g. of the proposed auditor reporting standard);
- A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit (paragraph 6.j. of the proposed auditor reporting standard);
- A statement that the audit was conducted in accordance with the standards of the PCAOB (paragraph 6.k. of the proposed auditor reporting standard);
- A statement that an audit includes evaluating the overall presentation of the financial statements (paragraph 6.m.(4) of the proposed auditor reporting standard);
- A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion (paragraph 6.n. of the proposed auditor reporting standard);
- An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then

ended in conformity with the applicable financial reporting framework.<sup>14/</sup> The opinion should also include an identification of the applicable financial reporting framework (paragraph 6.o. of the proposed auditor reporting standard);

- The signature of the auditor's firm<sup>15/</sup> (paragraph 6.q. of the proposed auditor reporting standard);
- The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued<sup>16/</sup> (paragraph 6.r. of the proposed auditor reporting standard); and
- The date of the auditor's report (paragraph 6.s. of the proposed auditor reporting standard).<sup>17/</sup>

## 2. *Basic Elements Incorporated from Existing Illustrative Reports*

In addition to the basic elements retained from the existing auditor reporting standards, the proposed auditor reporting standard also incorporates basic elements from the illustrative reports accompanying the existing reporting standards.<sup>18/</sup> Although these elements were not specifically required by existing auditor reporting standards,

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<sup>14/</sup> The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and required financial statements. For example, in an audit of an investment company, the auditor might use such terms as "the financial position," "the results of its operations," and "changes in its net assets" in the Opinion on the Financial Statements section of the auditor's report.

<sup>15/</sup> See also U.S. Securities and Exchange Commission ("SEC") Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

<sup>16/</sup> Id.

<sup>17/</sup> See AU sec. 530, *Dating of the Independent Auditor's Report*.

<sup>18/</sup> See illustrative reports on an audit of financial statements in existing AU sec. 508.08 and the Appendix of Auditing Standard No. 1.

the Board understands that, in practice, these elements generally are incorporated by auditors in the auditors' reports on financial statements filed with the SEC.<sup>19/</sup>

The proposed auditor reporting standard incorporates the following elements from the existing illustrative reports:

- The title, "Report of Independent Registered Public Accounting Firm" (paragraph 6.a. of the proposed auditor reporting standard);<sup>20/</sup>
- The name of the company whose financial statements were audited (paragraph 6.c. of the proposed auditor reporting standard); and
- The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report (paragraph 6.e. of the proposed auditor reporting standard).

The basic elements retained from the existing auditor reporting standards and incorporated from existing illustrative reports are generally understood by investors and other financial statement users and would continue to promote consistency among auditors' reports.

## **B. Changes to Certain Language in the Existing Auditor's Report**

The proposed auditor reporting standard would change the language for certain elements in the existing auditor's report. As further described below, the changes are being proposed in response to comments and to align the language with other PCAOB standards.

### *1. Addressees (Paragraph 6.b. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. The proposed auditor reporting standard indicates

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<sup>19/</sup> Based on the PCAOB staff's review of 125 Form 10-K filings for fiscal year 2011, all auditors' reports incorporated these basic elements.

<sup>20/</sup> An auditor, whether registered or not, may be legally required to, or may agree voluntarily to, perform an engagement in accordance with PCAOB standards of a non-issuer. If the proposed auditor reporting standard is adopted, PCAOB staff may issue guidance regarding such situations.

that addressees might include other appropriate parties depending on, for example, the legal and governance structure of the company. Accordingly, the auditor's report also could be addressed to others, such as bondholders.

Under existing AU sec. 508, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.<sup>21/</sup> Because the auditor is not required to address the auditor's report to a specific group, the auditor's report is not consistently addressed to the company's investors.<sup>22/</sup> In some instances, auditors address the auditor's report to the board of directors, or the company, rather than the company's investors.

Many commenters referred to investors as the "key customers" of the auditor's report, "the real client of the auditor," or "ultimately the ones paying for the auditor's opinions."<sup>23/</sup> Additionally, commenters suggested that the auditor's report should be addressed to the shareholders of the company in addition to the board of directors. In order to promote consistency in the addressees included in the auditor's report, the Board is proposing to require the auditor's report be addressed to investors in the company. The requirement for the auditor's report to be addressed to investors might serve as a reminder to the auditor that the auditor's ultimate customer is the investor.

2. *The Auditor's Responsibility for the Financial Statements, Including the Related Notes and, if Applicable, Schedules (Paragraph 6.f. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to identify the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.

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<sup>21/</sup> See existing AU sec. 508.09.

<sup>22/</sup> Based on the PCAOB staff's review of 125 Form 10-K filings for fiscal year 2011, there were approximately 5 percent of auditors' reports not addressed to investors.

<sup>23/</sup> See comments at the September 15, 2011 public roundtable on the alternatives presented in the concept release for changing the auditor's reporting model. See also United States v. Arthur Young, 465 U.S. 805, 819 note 15 (1984), which states, in part, "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries."

The proposed auditor reporting standard uses the term "financial statements" as used by the SEC, which includes all notes to the statements and all related schedules. The notes to the financial statements provide additional information about the financial statements, such as a summary of the significant accounting policies. The proposed auditor reporting standard also includes a sentence to clarify that the proposed auditor reporting standard and other PCAOB standards often refer to the notes as disclosures.<sup>24/</sup>

The schedules identified as part of the financial statements depend on the SEC's requirements for the type of issuer. For example, auditors of registered investment companies would refer to SEC Regulation S-X, 17 C.F.R. § 210.6-10, for the list of schedules required to be filed with the SEC, such as the summary schedule of investments in securities of unaffiliated issuers.

The proposed auditor reporting standard would not apply to supplemental schedules pursuant to AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, because those schedules are not considered part of the financial statements.<sup>25/</sup> The auditor should continue to look to the requirements of AU sec. 551 for the auditor's reporting responsibilities regarding supplemental schedules accompanying audited financial statements.<sup>26/</sup>

Under existing AU sec. 508, each financial statement audited is specifically identified in the auditor's report. Existing AU sec. 508 also describes the basic financial statements as the balance sheet, statement of income, statement of stockholders' equity, and statement of cash flows.<sup>27/</sup> The notes to the financial statements and, if applicable, the related schedules, are not identified as part of the financial statements under existing AU sec. 508. The proposed auditor reporting standard would require specific references to the related notes and, if applicable, schedules because those are

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<sup>24/</sup> See, e.g., Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>25/</sup> See AU sec. 551.03.

<sup>26/</sup> On July 12, 2011, the Board issued Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*, PCAOB Release No. 2011-005 (July 12, 2011) available at [http://pcaobus.org/Rules/Rulemaking/Docket036/PCAOB\\_Release\\_2011-005.pdf](http://pcaobus.org/Rules/Rulemaking/Docket036/PCAOB_Release_2011-005.pdf), which, if adopted, would supersede AU sec. 551.

<sup>27/</sup> Existing AU sec. 508.06 describes these as the basic financial statements.

identified as part of the financial statements pursuant to SEC Rule 1-01(b) of Regulation S-X.

Many commenters supported the addition of language in the auditor's report regarding the auditor's responsibilities for financial statement notes. Some commenters noted that this change would bring the auditor's report more in line with the actual responsibilities of auditors as set out in existing auditing standards and would give more prominence to the auditor's responsibility for such disclosures.

Since the related notes and, if applicable, schedules are an integral part of the audited financial statements, the Board is proposing to make clear in the auditor's report the auditor's responsibilities for the notes to the financial statements and related schedules.

The proposed auditor reporting standard also recognizes that not every company is required by the SEC to include related schedules as part of the financial statements. If, however, these schedules are required by the SEC to be included as part of the audited financial statements, the auditor's report also would identify these schedules.

3. *The Auditor's Responsibility for Fraud (Paragraph 6.I. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would revise the auditor's report to recognize the auditor's existing responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.<sup>28/</sup>

Existing AU sec. 508 does not require the auditor's report to describe the auditor's responsibility related to error or fraud in planning and performing the audit. This proposed change does not modify the auditor's existing responsibilities with respect to fraud in a financial statement audit.

Many commenters supported describing the auditor's responsibility for fraud in the auditor's report. Those commenters generally suggested modifying the language in the auditor's report to add the phrase "whether caused by error or fraud." Another commenter specifically noted that this description would help achieve the objective of enhancing communication between auditors and users of the auditors' reports.

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<sup>28/</sup> See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.



In the report by the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP"), ACAP requested the PCAOB to clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards.<sup>29/</sup> Additionally, academic research suggests that some users might benefit from a specific statement in the auditor's report regarding fraud.<sup>30/</sup>

4. *Description of the Nature of an Audit (Paragraph 6.m. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit but revises that description to align it better with the requirements in the Board's existing standards.

Under existing standards, the nature of an audit is described in the auditor's report as follows:<sup>31/</sup>

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

In 2010, the Board adopted eight standards (Auditing Standard Nos. 8-15) that improve the effectiveness of the auditor's identification of, assessment of, and response to the risks of material misstatement in an audit ("risk assessment standards"). The proposed auditor reporting standard updates the description related to the nature of the

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<sup>29/</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* ("ACAP report"), at VII:2 (October 6, 2008), available at <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>. See generally, ACAP report, at VII:13-VII:19.

<sup>30/</sup> See Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 *Accounting Horizons* 659, 675-676 (2011).

<sup>31/</sup> See existing AU sec. 508.08.f.

audit to reflect the auditor's responsibilities in a risk-based audit and to align the description with the language in the Board's risk assessment standards.

The proposed auditor reporting standard includes the following description of an audit:

- Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
- Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
- Evaluating the accounting principles used and significant estimates made by management; and
- Evaluating the overall presentation of the financial statements.

### **C. New Proposed Basic Elements Requirements**

The proposed auditor reporting standard adds new basic elements to the auditor's unqualified report that would enhance investors' and other financial statement users' understanding about the auditor and an audit.

#### *1. Auditor Independence (Paragraph 6.h. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws<sup>32/</sup> and the applicable rules and regulations of the SEC and the PCAOB.

Currently, the only indication of auditor independence in the auditor's report is in the title of the report "Report of Independent Registered Public Accounting Firm." Aside from the title, the auditor's report provides no further information regarding auditor

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<sup>32/</sup> The term "United States federal securities laws" has the same meaning as "securities laws" in PCAOB Rule 1001(s)(ii), *General Provisions*. "United States federal" has been added to distinguish for investors the country and governmental level (federal, state or local) of the referenced laws.

independence. The statement regarding auditor independence is not intended to affect auditor independence requirements under the securities laws, SEC rules,<sup>33/</sup> or PCAOB rules.<sup>34/</sup>

In the concept release, the Board sought comments on whether to include a statement in the auditor's report, in addition to the title, regarding the auditor's responsibilities related to independence. In general, commenters were supportive of this change with one commenter specifically noting that a stronger statement regarding auditor independence would both be informative for investors and a reminder to auditors of their obligation to be independent of the company.

According to a January 2008 U.S. Government Accountability Office report, "investors and other users of financial statements expect auditors to bring integrity, independence, objectivity, and professional competence to the financial reporting process and to prevent the issuance of misleading financial statements. The resulting sense of confidence in companies' audited financial statements, which is key to the efficient functioning of the markets for public companies' securities, can exist only if reasonable investors perceive auditors as independent and expert professionals who will conduct thorough audits."<sup>35/</sup> In the Board's view, adding a statement relating to auditor independence in the auditor's report could (1) enhance investors' and other financial statement users' understanding of the auditor's obligations to be independent and (2) serve as a reminder to auditors of these obligations.

## 2. *Auditor Tenure (Paragraph 6.i. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. Currently this information is not required to be communicated by the auditor (or by management or the audit committee) to investors and other financial statement users.

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<sup>33/</sup> See SEC Rule 2-01 of Regulation S-X, 17 C.F.R. § 210.2-01.

<sup>34/</sup> See PCAOB Rule 3520, *Auditor Independence, et seq.*

<sup>35/</sup> See U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, 7 (Jan. 2008), available at <http://www.gao.gov/new.items/d08163.pdf>.

Auditor tenure has been the subject of discussion for decades<sup>36/</sup> and continues to be a topic of discussion today.<sup>37/</sup> Some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.<sup>38/</sup> Meanwhile, other academic research indicates that investors that participated in a study view long-term auditor-company relationships as adversely affecting audit quality.<sup>39/</sup> Other academic research suggests that both short and long tenure can have detrimental effects on audit quality.<sup>40/</sup>

Disclosure of auditor tenure also has been considered by other regulators and standard setters. For example, under rules adopted by the United Kingdom ("UK")

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<sup>36/</sup> See, e.g., Staff of Subcomm. on Reports, Accounting and Management of the S. Comm. on Government Operations, 95th Cong., *The Accounting Establishment iii* (Comm. Print 1977), at 21, available at <http://archive.org/download/accstabl00unit/accstabl00unit.pdf>; see also AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 108, available at [http://www.sechistorical.org/collection/papers/1970/1978\\_0101\\_CohenAuditors.pdf](http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf).

<sup>37/</sup> See, e.g., Richard Crump, *FTSE 100 Providing More Audit Tenure Information*, Accountancy Age, June 14, 2013, available at <http://www.accountancyage.com/aa/news/2274992/ftse-100-providing-more-audit-tenure-information>.

<sup>38/</sup> See, e.g., Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 *Auditing: A Journal of Practice and Theory* 55, 55–69 (2004); and Bin Srinidhi, Sidney Leung, and Ferdinand A. Gul, *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge*, (2010), unpublished working paper available at <http://dx.doi.org/10.2139/ssrn.1590811>.

<sup>39/</sup> See, e.g., Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 *Accounting Horizons* 297, 297–314 (2008).

<sup>40/</sup> See, e.g., Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 *Contemporary Accounting Research* 517, 517–548 (2009).

Financial Reporting Council, UK-listed companies are required to provide information on the length of auditor tenure in a separate section of the annual report.<sup>41/</sup>

Regardless of whether auditor tenure is viewed as a positive or negative influence on audit quality, investors and other financial statement users have indicated strong interest in this information.<sup>42/</sup> In developing the proposed requirement, the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure. The Board's inspection process has not been designed to determine a relationship between audit quality and auditor tenure. In light of the public interest in the subject of auditor tenure, the Board is proposing to include auditor tenure as a data point in the auditor's report.

In determining the year the auditor began serving consecutively as the company's auditor, the auditor would look to the year beginning when the firm signs an initial engagement letter to audit a company's financial statements or when the firm begins the audit, whichever is earlier. For example, if the auditor is appointed in January 2012 to audit a company's financial statements for the year ended December 31, 2012, and the auditor's report is dated February 28, 2013, the auditor would state 2012 as the year the auditor began serving consecutively as the company's auditor. In another example, if the auditor is appointed in January 2013 to audit a company's financial statements for the years ended December 31, 2010, 2011, and 2012, the auditor would state 2013 as the year the auditor began serving consecutively as the company's auditor.

The intent of the proposed requirement is to disclose the duration of the auditor's relationship with the company. For example, in a situation in which a company acquires another company, if the acquirer's current auditor continues serving subsequently as the company's auditor, the auditor tenure would continue. If the acquired company's auditor is selected to serve as the acquirer's auditor, the auditor tenure would begin anew.

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<sup>41/</sup> See UK - Financial Reporting Council Corporate Governance Code and Auditing Standards at <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>.

<sup>42/</sup> On April 19, 2013, the Council of Institutional Investors revised its corporate governance policies to state that "boards retaining an auditor beyond 10 years should be required to explain why doing so is in shareholders' interest." The revisions made to the Council of Institutional Investors' Policies on Corporate Governance are available at: [http://www.cii.org/corp\\_gov\\_policies](http://www.cii.org/corp_gov_policies).

Additionally, the auditor's relationship with the company is not affected by the company's status as a public company. For instance, if a company went public but maintained its auditor, the auditor tenure would include the years the auditor served as the company's auditor both before and after the company became subject to the SEC financial reporting requirements.

The Board understands that, in some cases, the auditor may have difficulty determining the year the auditor began serving as the company's auditor, due to firm or company mergers, acquisitions, or changes in ownership structure. If the auditor is unaware of the year it became the company's auditor, the auditor could refer to publicly available information, such as the SEC's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") for determining the year the auditor or the auditor's predecessor firm began serving as the company's auditor.<sup>43/</sup> EDGAR also may be used by investors to assess whether a company has filed a current report on Form 8-K to disclose a change in the company's auditor.<sup>44/</sup>

If the auditor is unable to obtain information regarding the year the auditor began serving consecutively as the company's auditor, the auditor would be required to state in the auditor's report that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge. As noted above, this might apply in situations in which other firms were acquired by the auditor's firm or were merged with the auditor's firm, or in situations in which the company's ownership structure changed. The following is an example of such a statement that could be included in the auditor's report:

We are uncertain as to the year we [or our predecessor firms] began serving consecutively as the auditor of the Company's financial statements; however, we are aware that we [or our predecessor firms] have been Company X's auditor [or Company X's auditor subsequent to the Company's merger] consecutively since at least 19XX.

The auditor may incur some initial costs to determine the year the auditor began serving consecutively as the company's auditor, but once the year has been determined the cost to include the disclosure about tenure should be minimal.

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<sup>43/</sup> Many company's filings are available via EDGAR starting in 1994.

<sup>44/</sup> See Form 8-K, 17 C.F.R. § 249.308, Item 4.01 Changes in Registrant's Certifying Accountant.



3. *Other Information (Paragraph 6.p. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to refer to the reporting requirements contained in the Board's companion Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, (the "proposed other information standard") when the auditor's report is included in a company's annual report filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") that includes other information outside the company's audited financial statements as well as the audited financial statements and the related auditor's report.

When issuing an auditor's report, the reporting requirements of the proposed other information standard would require the auditor to include in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information" the following:

- a. A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)], in accordance with the standards of the PCAOB, the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;
- b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;
- c. A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;
- d. A statement that the auditor did not audit the other information and does not express an opinion on the other information; and
- e. A statement that, based on the evaluation, the auditor:
  - (1) Has not identified a material inconsistency or a material misstatement of fact in the other information,<sup>45/</sup> or

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<sup>45/</sup> This statement is appropriate in situations in which the auditor (1) has not identified a material inconsistency or a material misstatement of fact or (2) has identified

- (2) Has identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

In the concept release, the Board requested comments on whether the auditor's report should describe the auditor's responsibility with respect to other information. Some commenters supported including a description of the auditor's responsibilities with respect to other information outside the financial statements in the auditor's report. Some of these commenters indicated that a description of the auditor's responsibilities would be helpful for investors' and other financial statement users' understanding of the auditor's responsibilities with respect to other information and would address any misperception that the other information is audited. A number of commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed in addition to the description of the auditor's responsibilities regarding other information.

The proposed other information standard would strengthen the audit procedures the auditor would perform related to other information outside the financial statements when such information is included in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report. The proposed other information standard would provide a basis for enhancing the auditor's report regarding the auditor's responsibilities for other information and the results of the auditor's evaluation of the other information. These changes are intended to make the auditor's report more informative.<sup>46/</sup>

#### **D. Form of the Auditor's Unqualified Report**

The basic elements of the proposed auditor's unqualified report are organized and categorized into introduction, basis of opinion, opinion on the financial statements, auditor's responsibilities regarding other information, and signature and date sections in the proposed auditor reporting standard. This categorization would replace previous references in PCAOB standards to introductory, scope, and opinion paragraphs. The purpose for this change is primarily to assist readers of the proposed auditor reporting

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a material inconsistency, a material misstatement of fact, or both, that management has revised appropriately prior to the issuance of the auditor's report.

<sup>46/</sup> See Appendix 6 for proposed changes related to the auditor's responsibilities regarding other information.

standard to understand the standard as well as to provide easy reference to specific sections within the auditor's report.

One proposed change in the form of the report involves the replacement of the "scope paragraph" in existing AU sec. 508, which describes the nature of an audit,<sup>47/</sup> with a "Basis of Opinion" section. The proposed change in terminology is based on the statement in the auditor's unqualified report that "we believe our audits provide a reasonable basis for our opinion."

The proposed auditor reporting standard does not require that the basic elements appear in a specific order in the auditor's report, nor does it require that section titles be included, except for the section titles regarding the auditor's responsibilities for other information and critical audit matters. The proposed auditor reporting standard does not preclude the auditor from including section titles for other sections in the auditor's report.

Questions Related to Section IV:

2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?
3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?
4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?
5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.

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<sup>47/</sup> See existing AU sec. 508.08.

- a. Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?
  - b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?
  - c. Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?
6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?
  7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?
  8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?
  9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.

**V. Critical Audit Matters (Paragraphs 7 – 14 of the Proposed Auditor Reporting Standard)**

The current version of the auditor's report includes the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail). Beyond the pass/fail nature of the report, the report provides little, if any, information specific to the audit of the company's financial statements. The proposed auditor reporting standard would require the auditor to communicate specific information through the auditor's

report regarding "critical audit matters," which would result in information in auditors' reports tailored to the audit.<sup>48/</sup>

The Board developed its proposal for communicating critical audit matters in the auditor's report in a way that should provide greater insight regarding the audit, without unduly burdening the financial reporting process. The auditor is well positioned to communicate this type of information to investors and other financial statement users through the auditor's report. Under the proposed auditor reporting standard, the auditor would determine critical audit matters by leveraging audit work already required to be performed under existing standards. The proposed auditor reporting standard does not intend to change the auditor's traditional role of attesting to matters in the financial statements and will not require auditors to provide analysis of the matters in the financial statements when communicating critical audit matters. Notably, the auditor's communication of critical audit matters would represent matters that have been addressed by the auditor in forming the opinion on the financial statements. Therefore, the communication of critical audit matters is not intended to, and should not, detract from, disclaim, or qualify the auditor's opinion.

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.<sup>49/</sup> Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. A more informative auditor's report could benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown

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<sup>48/</sup> The communication of critical audit matters also would be required in an auditor's report with a qualified opinion. See further discussion in Section VII, F. *Amendments to Existing AU sec. 508*.

<sup>49/</sup> See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 *Journal of Accounting and Economics* 337, 337-386 (2003).

information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry<sup>50/</sup> that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.<sup>51/</sup>

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee to matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the quality of the information<sup>52/</sup> in the financial statements. Academic research has indicated that increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.<sup>53/</sup>

Communication of critical audit matters under the proposed auditor reporting standard, however, could result in additional effort involving both one-time costs and

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<sup>50/</sup> Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

<sup>51/</sup> See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553, 1553-1583 (2004).

<sup>52/</sup> The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 *Journal of Accounting Research* 1, 1-42 (1982).

<sup>53/</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1-29 (2011).



recurring costs in each individual audit relative to the determination, preparation of language for communication, and documentation of critical audit matters in the auditor's report. Companies, including audit committees will likely also incur additional costs in reviewing the critical audit matters in the auditor's report. Section V.F., *Other Considerations for Critical Audit Matters*, of this Appendix provides a more detailed discussion regarding costs and related questions associated with the requirements for critical audit matters.<sup>54/</sup>

There also could be potential unintended consequences associated with requiring auditors to communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit, which might reduce the time available to the auditor to review and complete the audit work.

Additionally, as critical audit matters in the auditor's report would not be something that investors and other financial statement users are accustomed to reviewing or analyzing, investors and other financial statement users could misunderstand the meaning of a critical audit matter. Further, investors may not understand that information important to an investment decision may not be highlighted as a critical audit matter. However, as financial statement disclosures have changed over time, investors and other financial statement users are accustomed to reviewing or analyzing new or different information. Therefore, such users should have the ability to interpret the meaning of critical audit matters communicated in an auditor's report.

**A. Definition of Critical Audit Matters (Paragraph A2 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard defines critical audit matters as those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

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<sup>54/</sup> In addition, the discussion regarding costs for auditors related to critical audit matters appears in two different areas as follows: (1) recurring costs are discussed under each proposed requirement for critical audit matters throughout this Section and (2) one-time costs are discussed in Section V.F., *Other Considerations for Critical Audit Matters*, of this Appendix.

The auditor might identify either one matter or a number of matters that meet the definition of a critical audit matter. It is expected that, in most audits, there could be several matters that would meet the definition of a critical audit matter. Use of the word "most" in the definition of a critical audit matter does not imply that only one matter under each criteria would qualify as a critical audit matter. The word most also is not intended to imply that there is only one matter that surpasses all other matters; but rather to refer to the matter or matters that would stand out from the other numerous matters addressed during an audit in terms of difficulty, subjectivity, or complexity, as stated in the critical audit matters definition. Additionally, an audit matter could meet one, two, or all three of the criteria in the definition.

1. *Involved the Most Difficult, Subjective, or Complex Auditor Judgments*

The auditor exercises judgment in a variety of ways throughout an audit of financial statements. For instance, auditor judgment is used in determining the nature, timing, and extent of audit procedures; evaluating sufficient appropriate audit evidence; and forming an opinion on the financial statements.

The proposed auditor reporting standard anticipates that the auditor would determine what matters addressed during the audit involved the most difficult, subjective, or complex auditor judgment for communication in the auditor's report. The degree of difficulty, subjectivity, or complexity of auditor judgments can vary depending on the matter. For instance, matters that are subjective in nature generally would require a greater degree of auditor judgment than matters that are objective. Similarly, matters that are difficult or complex might require a greater degree of auditor judgment than matters that are relatively straightforward. For example, the auditor might determine that auditing the allowance for loan losses of a bank represented one of the areas that involved the most difficult, subjective, or complex auditor judgments because of (1) the high degree of complexity and subjectivity associated with evaluating the determination of the allowance for loan losses; (2) the significance of the assumptions in the accounting estimate, including the possibility of reasonable alternative assumptions; and (3) the high degree of uncertainty associated with the assumptions.

2. *Posed the Most Difficulty to the Auditor in Obtaining Sufficient Appropriate Evidence*

Audit evidence may be obtained by the auditor from several different sources, for example, from management; third parties, such as through confirmation; or from the auditor's own procedures, such as observation. The sufficiency of audit evidence is the

measure of its quantity, whereas the appropriateness is the measure of its quality, that is, its relevance and reliability.<sup>55/</sup>

The auditor might experience difficulty in obtaining sufficient appropriate evidence in several ways. For instance, difficulty might result from unexpected extensive effort required by the auditor to obtain evidence. Difficulty could also result when the auditor obtains information that conflicts with audit evidence previously obtained, thereby raising questions about the reliability of the audit evidence.

Those matters arising in the audit that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence would be communicated in the auditor's report under the proposed auditor reporting standard. For example, the auditor might determine that auditing fair value measurements of certain financial instruments represented one of the areas that posed the most difficulty in obtaining sufficient appropriate evidence because the auditor encountered difficulties in obtaining relevant and reliable evidence regarding observable inputs in an inactive market. In situations where there is little market activity, the auditor may need to evaluate unobservable inputs to measure fair value, which requires the auditor's assessment of the assumptions that market participants would use to price an asset or liability.<sup>56/</sup>

3. *Posed the Most Difficulty to the Auditor in Forming the Opinion on the Financial Statements*

Matters that posed the most difficulty to the auditor in forming the opinion on the financial statements are those matters arising from the audit that commenters described

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<sup>55/</sup> See paragraphs 5 and 6 in Auditing Standard No. 15, *Audit Evidence*.

<sup>56/</sup> See Financial Accounting Standard Board's ("FASB") Accounting Standard Codification ("ASC") Topic 820, *Fair Value Measurements*, and International Accounting Standards Board's International Financial Reporting Standard No. 13, *Fair Value Measurement*, which define Level 3 inputs as unobservable inputs that are used to estimate the fair value of the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing a fair value measurement in situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the assumptions (including assumptions about risk) that market participants would use when pricing the asset or liability.

as "close calls" or matters that "kept the auditor up at night."<sup>57/</sup> The types of matters that would meet this criteria represent matters that concerned the auditor when the auditor was making the final assessment of whether the financial statements present fairly the company's financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework.<sup>58/</sup>

Those matters arising in the audit that posed the most difficulty to the auditor in forming the opinion on the financial statements would be communicated in the auditor's report under the proposed auditor reporting standard. For example, the auditor might determine that revenue recognition represented an area that posed the most difficulty to the auditor in forming the opinion on the financial statements because the authoritative revenue recognition guidance is not directly applicable to the company's product sales raising challenges for the auditor in determining if revenue recognition principles were properly applied.

**B. Determination of Critical Audit Matters (Paragraphs 7 – 9 of the Proposed Auditor Reporting Standard)**

*1. Requirement to Determine Critical Audit Matters (Paragraphs 7 and 8 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to determine the critical audit matters addressed in the audit of the current period's financial statements based on the results of the audit or evidence obtained.

Under the proposed auditor reporting standard, it is expected that, in most audits, the auditor would determine that there are critical audit matters. The proposed auditor reporting standard does not provide for an explicit exception from determining whether there are any critical audit matters for audits of certain types of entities. Since no two audits are alike, there may be critical audit matters even in an audit of a company with no operations or activities.

In determining the critical audit matters the auditor addressed during the audit, the auditor would leverage the work he or she already performed when conducting an

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<sup>57/</sup> See, e.g., comments made during the PCAOB's Roundtable on the Auditor's Reporting Model. The transcript is located at [http://pcaobus.org/Rules/Rulemaking/Docket034/09152011\\_Roundtable\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf).

<sup>58/</sup> See paragraph 1 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

audit under the Board's existing standards. Those standards currently require the auditor to perform various procedures to provide a foundation for the auditor's significant judgments and conclusions on which the auditor's opinion on the financial statements is based. The audit procedures applied throughout the audit are based primarily upon an auditor's identification of, assessment of, and response to the risk of material misstatement. The proposed auditor reporting standard would result in the auditor reporting on the most difficult and challenging aspects of the audit. The proposed auditor reporting standard does not impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

Because critical audit matters ordinarily are matters of such importance, they would be included in the matters required to be (1) documented in the engagement completion document under Auditing Standard No. 3, *Audit Documentation*; (2) reviewed by the engagement quality reviewer under Auditing Standard No. 7, *Engagement Quality Review*; (3) communicated to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees* or other PCAOB standards; or (4) any combination of the three. The auditor's documentation and activities under these standards could provide the auditor with sources for identifying critical audit matters. However, the Board would not expect that each matter included in any one or more of these sources would be a critical audit matter.

The auditor's determination and communication of critical audit matters is not intended to take the place of the auditor's existing responsibilities under other audit performance and reporting standards. For example, the auditor's responsibilities associated with the auditor's consideration of an entity's ability to continue as a going concern and the related reporting requirements,<sup>59/</sup> and the auditor's communication of control deficiencies related to an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only,<sup>60/</sup> among other audit performance and/or reporting requirements, continue to exist unchanged. In addition, the communication of critical audit matters is not intended to function as an alternative to a departure from an unqualified opinion on the financial statements in difficult or challenging situations.

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<sup>59/</sup> See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and paragraph 15.a. of the proposed auditor reporting standard, which is being retained from the existing standard (AU sec. 508.11.b).

<sup>60/</sup> See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*.



Although the proposed auditor reporting standard is intended to leverage the work the auditor already performed when conducting an audit under the Board's existing standards, it could increase the auditor's focus on critical audit matters, which could result in enhancing the quality of the audit. Previous research has found that auditors increase audit hours and/or billing rates in response to audit risks.<sup>61/</sup> Although an increase in audit hours and/or billing rates likely would increase audit fees, an increase in focus on critical audit matters could also result in increased audit quality.<sup>62/</sup>

In determining critical audit matters under the proposed auditor reporting standard, auditors likely would incur recurring costs due to additional effort expended in individual audits. It is likely that senior members of the engagement teams, such as partners and senior managers, would be involved with determining the critical audit matters to be communicated in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office could also result in recurring costs.<sup>63/</sup>

## 2. *Factors (Paragraph 9 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard includes a list of factors intended to help the auditor determine, from the results of the audit or evidence obtained, which matters in the audit would meet the definition of critical audit matters. Depending on the matter and its circumstances, the applicability and related degree or scope of just one factor might lead an auditor to conclude that a matter is a critical audit matter. In other cases, however, the auditor might take into consideration a combination of factors in determining that a matter is a critical audit matter.

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<sup>61/</sup> See Jean C. Bedard and Karla M. Johnstone, *Earnings Manipulation Risk, Corporate Governance Risk, and Auditors' Planning and Pricing Decisions*, 79 *The Accounting Review* 277, 277-304 (2004). See also Mark F. Zimbleman, *The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions*, 35 *Journal of Accounting Research* 75, 75-97 (1997).

<sup>62/</sup> See Gerald Lobo and Yuping Zhao, *Relation Between Audit Effort and Financial Report Misstatements: Evidence from Quarterly and Annual Restatements*, 88 *The Accounting Review* 1385, 1385-1412 (2013).

<sup>63/</sup> See also Section V.F., *Other Considerations for Critical Audit Matters*, of this Appendix for a more detailed discussion regarding costs associated with the requirements for critical audit matters under the proposed auditor reporting standard.



In addition, the factors in the proposed auditor reporting standard are not intended to represent an all-inclusive list of factors pertaining to whether a matter meets the definition of a critical audit matter. There could be other factors that may be specific to the audit, which are not listed in the proposed auditor reporting standard, that affect whether a matter involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, or posed the most difficulty to the auditor in forming an opinion on the financial statements.

The factors listed in the proposed auditor reporting standard are:

- a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures (paragraph 9.a. of the proposed auditor reporting standard)

A high degree of subjectivity may be involved in auditing matters that are complex or unusual, or both. For example, the arrangements pursuant to which a company recognizes revenue might be complex and require significant judgments regarding the development of estimates, such as the fair value of certain deliverables pursuant to a multiple element sales contract. In this example, determining or applying the appropriate audit procedures to test management's fair value measurements, or to evaluate whether management's estimates are reasonable, might involve one of the most subjective auditor judgments during the audit.

- b. The nature and extent of audit effort required to address the matter (paragraph 9.b. of the proposed auditor reporting standard)

The nature and extent of audit effort relates to the time spent by the engagement team members performing the audit procedures; the level of knowledge, skill, and ability of engagement team members necessary to audit the matter;<sup>64/</sup> the extent of supervision needed based on the assessed risks of material misstatements;<sup>65/</sup> and the extent of discussions with management or within the firm,<sup>66/</sup> such as the firm's national office, or consultations outside the firm.

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<sup>64/</sup> See paragraph 6.d. of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

<sup>65/</sup> See paragraph 5.b. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>66/</sup> See paragraph 19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

An area that requires extensive audit effort might be an indicator that the matter was among the most difficult during the audit or required a significant amount of judgment. Matters that required extensive audit effort could include the significant involvement of more experienced engagement team members or an increase in the amount of time incurred in (1) supervising the auditing of the matter; (2) discussing the matter with management and the audit committee; or (3) consulting with the firm's national office about the matter.

- c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence (paragraph 9.c. of the proposed auditor reporting standard)

The sufficiency and appropriateness of the audit evidence obtained to support the matter, such as when the auditor identifies contrary evidence, might contribute to the degree of difficulty in applying audit procedures to address the matter.

Delays by management, the unavailability of company personnel, or unwillingness by management to provide information needed for the auditor to perform his or her audit procedures also could create challenges associated with obtaining relevant and reliable audit evidence.<sup>67/</sup>

- d. The severity of control deficiencies identified relevant to the matter, if any (paragraph 9.d. of the proposed auditor reporting standard)

In both an audit of the financial statements and an audit of internal control over financial reporting that is integrated with an audit of financial statements, the auditor is required to obtain a sufficient understanding of internal control over financial reporting.<sup>68/</sup> In an integrated audit, the auditor would be required to audit the effectiveness of internal control over financial reporting.<sup>69/</sup> And in a financial statement audit, the auditor would be required to reach an understanding of the internal control over financial reporting and the company's control activities sufficient to assess the risk

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<sup>67/</sup> Difficulties encountered by the auditor during the audit could represent a scope limitation, which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement. See AU secs. 508.22-.32.

<sup>68/</sup> See paragraphs 18-40 of Auditing Standard No. 12.

<sup>69/</sup> See paragraph 1 of Auditing Standard No. 5.

of material misstatement in the financial statements and to design further audit procedures.<sup>70/</sup>

Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.

Although an auditor might determine a matter to be a critical audit matter because of the severity of an internal control deficiency, the communication of such a critical audit matter would not relieve the auditor from the auditor's existing auditing and reporting responsibilities under other PCAOB standards related to a company's internal control over financial reporting.<sup>71/</sup> This factor is intended to help the auditor determine which matters are critical audit matters and is not intended to supplement, replace, or create new audit requirements for matters related to internal control over financial reporting.

- e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any (paragraph 9.e. of the proposed auditor reporting standard)

The Board's risk assessment standards require the auditor to modify, among other things, the audit strategy, materiality levels, and the assessment of the risks of material misstatement if circumstances change during the course of the audit. Such changes could result from the discovery of a previously unidentified risk of material misstatement or audit evidence that contradicts the auditor's initial risk assessment. Also, the number of misstatements found by the auditor might be indicative that other misstatements might exist.

Since a matter that resulted in changes to the planned audit strategy or to changes to the risks initially identified could involve significant auditor judgment, it might be a critical audit matter.

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<sup>70/</sup> See paragraph 34 of Auditing Standard No. 12.

<sup>71/</sup> See Auditing Standard No. 5, Auditing Standard No. 12, and AU sec. 325.

- f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any (paragraph 9.f. of the proposed auditor reporting standard)

In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor's evaluation of audit results should include an evaluation of misstatements accumulated during the audit, including uncorrected misstatements.<sup>72/</sup> Misstatements can arise from error (that is, unintentional misstatement) or fraud.<sup>73/</sup>

A matter in which misstatements, either corrected or uncorrected, have been identified might lead the auditor to conclude that the matter is a critical audit matter.

- g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any (paragraph 9.g. of the proposed auditor reporting standard)

In auditing matters that are complex or subjective, the auditor may determine that using the work of a specialist to obtain sufficient appropriate evidence is necessary. For example, specialized skill or knowledge might be needed by the auditor in areas such as the valuation of complex financial instruments, determination of mineral reserves, actuarial determinations, or interpretation of technical requirements.

An auditor's determination that a matter required specialized skill or knowledge to obtain sufficient appropriate evidence might be an indication that the matter involved difficult, subjective, or complex auditor judgments. In such situations, the matter might be a critical audit matter.

- h. The nature of consultations outside the engagement team regarding the matter, if any (paragraph 9.h. of the proposed auditor reporting standard)

Issues that are complex or unusual can arise in various stages during the audit. In such situations, the auditor might consult with the firm's national office, industry specialists, or external parties. For example, matters related to the auditor's evaluation of management's judgments, estimates, or accounting policies might lead to

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<sup>72/</sup> See paragraphs 3-4 and 10-23 of Auditing Standard No. 14, *Evaluating Audit Results*.

<sup>73/</sup> See paragraph A2 of Auditing Standard No. 14.

consultation with others who might assist the auditor in arriving at the conclusions on which the auditor's opinion is based. Such matters might involve the most subjective or complex auditor judgments during the audit or might pose the most difficulty in forming an opinion on the financial statements. Consultation with others on a particular matter, therefore, might be an indication that the matter is a critical audit matter.

**C. Audit Period Covered by Critical Audit Matters (Paragraph 10 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard would require the auditor to communicate critical audit matters for the audit of the current period's financial statements. While most companies' financial statements are presented on a comparative basis, and thus most audit reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented in the financial statements, would provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users would be able to look at prior years' filings to analyze critical audit matters over time.

Because the communication of critical audit matters for prior periods also might be useful to investors and other financial statement users, the proposed auditor reporting standard states that, when the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

In situations in which a predecessor auditor has been asked to reissue his or her audit report on the financial statements of a prior period, existing standards require the auditor to consider whether the auditor's report on those statements is still appropriate after certain required procedures are performed.<sup>74/</sup> If the predecessor auditor determines that the auditor's report is still appropriate and is reissued, the communication of critical audit matters for the prior period need not be repeated. Since the communication of critical audit matters is only required for one year, the proposed auditor reporting standard would not require the communication of critical audit matters in the reissued report of the predecessor auditor for prior years.

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<sup>74/</sup> See AU secs. 508.70-.73, which discusses the report of a predecessor auditor.

**D. Communication in the Auditor's Report of Critical Audit Matters  
(Paragraphs 11 – 13 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard would require that, for each critical audit matter communicated in the auditor's report, the auditor (1) identify the critical audit matter; (2) describe the considerations that led the auditor to determine that the matter is a critical audit matter; and (3) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

The Board expects that the auditor's communication of critical audit matters in the auditor's report would be presented in language and in a format that is clear, concise, and understandable to a financial statement user. The Board also expects that the communication would be tailored to the audit and thus would avoid boilerplate language and reflect the specific circumstances of the matter in relation to the audit of the company's financial statements. While the same audit matter may be determined to be a critical audit matter from one year to the next or from one audit to another, the auditor would be expected to tailor the communication of the critical audit matter to the specific facts and circumstances that existed during that particular current period's audit.

As noted previously, the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements taken as a whole. Accordingly, the proposed auditor reporting standard indicates that the auditor should not use language in the auditor's report that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements. In issuing an unqualified opinion on the financial statements, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements, taken as a whole, are fairly presented in all material respects. Critical audit matters in the auditor's report are matters that have been addressed by the auditor and, therefore, should not be described to imply that a critical audit matter disclaims or qualifies the auditor's opinion on the financial statements.

The following discussion presents the proposed elements of the communication in the auditor's report relative to critical audit matters in more detail.

*1. Identify the Critical Audit Matter (Paragraph 11.a. of the Proposed Auditor Reporting Standard)*

In communicating the critical audit matter, the auditor would identify each audit matter that the auditor determined met the definition of a critical audit matter. For example, the audit of the valuation of certain complex financial instruments could be identified as a critical audit matter in the auditor's report because the matter posed the most difficulty to the auditor in obtaining sufficient appropriate evidence.



2. *Describe the Considerations That Led the Auditor to Determine That the Matter is a Critical Audit Matter (Paragraph 11.b. of the Proposed Auditor Reporting Standard)*

To enhance investors' and other financial statement users' understanding of the audit, the proposed auditor reporting standard would require the auditor to describe the considerations that led the auditor to determine that the matter is a critical audit matter. The description of considerations that led the auditor to determine a matter is a critical audit matter may be derived from one or more of the factors; however, the auditor would not be limited to the factors listed in the proposed auditor reporting standard, which also could include other factors specific to the audit. Additionally, the auditor's description should be specific to the circumstances. For instance, using the same example from above regarding certain complex financial instruments that are identified as a critical audit matter, the communication in the auditor's report might describe the auditor's considerations related to the lack of observable inputs, a high degree of measurement uncertainty, and significant judgments needed to audit the fair value assumptions. Further, when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so.

3. *Refer to the Relevant Financial Statement Accounts and Disclosures That Relate to the Critical Audit Matter, When Applicable (Paragraph 11.c. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard also would require the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable. Since the audit is of the company's financial statements, the auditor would be able to refer to the relevant financial statement accounts and disclosures in most cases. Following through on the example from above in which the critical audit matter was the valuation of certain complex financial instruments, the auditor would refer to the relevant financial statement account for financial instruments and the corresponding disclosure.

There also may be instances when a critical audit matter has a pervasive effect on the financial statements, such as an entity level control deficiency or circumstances in which there is no related financial statement account or disclosure. In such cases, the auditor would describe the matter and its effect on the audit of the financial statements, taken as a whole.

With regard to each of the proposed elements of the communication in the auditor's report, developing the language of critical audit matters to include in the auditor's report likely would result in additional recurring costs related to individual

audits. These recurring costs likely would include additional time incurred by senior members of engagement teams, such as partners and senior managers. In addition, other recurring costs might relate to additional time incurred by others, such as the engagement quality reviewer and consultations with others, including national office. Further, additional time also might be incurred by the auditor as a result of discussions with management or the audit committee regarding the critical audit matters to be communicated in the auditor's report under the proposed auditor reporting standard.<sup>75/</sup>

#### 4. *Illustrative Examples of Critical Audit Matters*

The Exhibit to this Appendix includes illustrative examples of communications of critical audit matters in the auditor's report. The Board has developed three different scenarios that contain background information, the company's related notes to the financial statements, determination of the critical audit matter, and the communication of the critical audit matter as it would appear in the auditor's report.<sup>76/</sup>

The Board is interested in obtaining other illustrative examples of communications of critical audit matters under the proposed auditor reporting standard. Thus, the Board is requesting that commenters prepare examples of communications of critical audit matters that could appear in an auditor's report under the proposed auditor reporting standard and provide those examples to the Board.<sup>77/</sup>

#### 5. *Language Preceding Critical Audit Matters (Paragraphs 12 and 13 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include a section titled "Critical Audit Matters" and include specific language in the auditor's report both when critical audit matters are being communicated and when the auditor has determined that there are no critical audit matters to communicate. In both situations,

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<sup>75/</sup> See also Section V.F., *Other Considerations for Critical Audit Matters*, of this Appendix for a more detailed discussion regarding costs associated with the requirements for critical audit matters under the proposed auditor reporting standard.

<sup>76/</sup> The examples contained in the Exhibit to this Appendix are based on hypothetical situations and have been prepared for illustrative purposes only. They are not intended to provide guidance or any suggestions regarding the accounting or disclosure required, nor any implied audit procedures, in the circumstances presented.

<sup>77/</sup> Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

the language in the auditor's report is intended to inform investors and other financial statement users of the auditor's requirement to communicate critical audit matters and whether the auditor has determined there are any critical audit matters.

When the auditor determines that there are critical audit matters, the specific language for such situations notifies investors and other financial statement users that the auditor's communication of critical audit matters is not intended to affect the auditor's opinion on the financial statements and related disclosures, taken as a whole, and therefore, does not represent individual opinions for each critical audit matter.

In situations in which the auditor determines that there are no critical audit matters, the proposed specific language in the auditor's report would describe the auditor's responsibilities and indicate that the auditor determined that there are no critical audit matters.

**E. Documentation of Critical Audit Matters (Paragraph 14 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard requires the auditor to document the auditor's determination of critical audit matters and refers the auditor to the documentation requirements for audits conducted under PCAOB standards (that is, Auditing Standard No. 3). To provide sufficient detail for a clear understanding of the conclusions reached by the auditor, the auditor's documentation related to critical audit matters should contain sufficient information to enable an experienced auditor,<sup>78/</sup> having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters that would appear to meet the definition of a critical audit matter were not critical audit matters.

As noted previously, in determining critical audit matters, the proposed auditor reporting standard anticipates that auditors would leverage the audit work already performed under existing auditing standards. This includes the information documented in the engagement completion document, matters reviewed by the engagement quality reviewer, or matters communicated to the audit committee. The auditor's documentation and activities under existing standards could provide the auditor with sources for identifying critical audit matters.

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<sup>78/</sup> See note to paragraph 6 of Auditing Standard No. 3, which states that "[a]n *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

In fulfilling the documentation requirements under the proposed auditor reporting standard, the auditor would not be expected to provide an explanation for each matter documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee. The Board recognizes that documenting whether each such matter was a critical audit matter could result in an extensive amount of documentation that might be unnecessary. Accordingly, the auditor would be expected to document only those matters that were either communicated as critical audit matters or that would appear to meet the definition of a critical audit matter that were not communicated as such in the auditor's report.

*1. Audit Matters Reported as Critical Audit Matters*

As noted previously, the documentation of those matters the auditor communicated as critical audit matters would be required to meet the documentation requirements of Auditing Standard No. 3. That standard requires an auditor to prepare audit documentation that is in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached.<sup>79/</sup> In addition, Auditing Standard No. 3 requires that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the conclusions reached.<sup>80/</sup>

*2. Audit Matters Not Reported as Critical Audit Matters*

The Board is proposing a documentation requirement that is intended to encourage auditors to consider in a thoughtful and careful manner whether all matters that meet the definition of a critical audit matter are communicated in the auditor's report. The proposed auditor reporting standard would require the auditor to document why audit matters that would appear to meet the definition of a critical audit matter were not communicated as such by the auditor in the auditor's report.

Additionally, the Board is proposing this requirement to help the auditor and other reviewers, such as the engagement quality reviewer, have a better understanding of the basis for the auditor's determination of matters that would appear to meet the definition of a critical audit matter and were not communicated. Further, requiring documentation of the auditor's determination of such matters not communicated might have the indirect effect of preventing the omission of a critical audit matter due to potential management pressure to exclude the matter from the auditor's report.

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<sup>79/</sup> See paragraph 2 of Auditing Standard No. 3.

<sup>80/</sup> See paragraph 6 of Auditing Standard No. 3.

The proposed documentation requirement of why audit matters that would appear to meet the definition of a critical audit matter were not communicated by the auditor in the auditor's report would reflect the requirements of Auditing Standard No. 3. For instance, if a matter was included in the engagement completion document, reviewed by the engagement quality reviewer, and communicated to the audit committee, it could appear to an experienced auditor having no previous connection to the audit, after also considering the factors in paragraph 9 of the proposed auditor reporting standard, that the matter met the definition of a critical audit matter. If the auditor determined that such a matter was not a critical audit matter, then the auditor would document the basis for the determination in the auditor's working papers with sufficient detail to explain the basis of the conclusions reached.

The auditor's documentation of critical audit matters under the proposed auditor reporting standard likely would result in additional recurring costs to the firm due to efforts expended in individual audits. These recurring costs likely would include additional time incurred to prepare documentation in sufficient detail to address the proposed requirements. This also might include additional review time incurred by others, such as senior members of the engagement team or the engagement quality reviewer.

#### **F. Other Considerations for Critical Audit Matters**

Enhancing auditor reporting requirements necessarily will involve changes in practice, related cost implications and other challenges. Discussed below are potential economic considerations that might be relevant to auditors and companies, including audit committees. Also, discussed below are potential effects of disclosing information through the communication of a critical audit matter that otherwise would not be required to be disclosed under existing auditor or financial reporting standards, and liability considerations for auditors.

##### *1. Effects of Additional Effort by Auditors and Companies, Including Audit Committees*

Based on its outreach to date, the Board anticipates that the communication of critical audit matters likely would have potential cost implications for auditors and companies, including their audit committees. Such costs would include those related to additional time to prepare and review auditors' reports.

### *Auditors*

For auditors, costs might represent both one-time costs and recurring costs. The recurring costs for auditors regarding critical audit matters under the proposed auditor reporting standard have been discussed previously.<sup>81/</sup> The one-time costs for auditors could be incurred as a result of (1) updating firm audit and quality control methodologies to reflect the new reporting requirements and (2) developing and conducting training of firm personnel on the new reporting requirements. When updating methodologies, some firms also likely would develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters in the draft auditor's report, which also would result in incremental one-time costs.

### *Companies, Including Audit Committees*

Companies, including audit committees, could incur additional recurring costs as a result of the proposed auditor reporting standard. For instance, audit fees may increase due to the new reporting requirements in the Board's proposal. Additionally, companies might incur one-time costs in developing, and recurring costs in performing, internal processes for the review of critical audit matters in the draft auditor's report and the related interaction with auditors and others.

Audit committees might also incur additional time for the review of critical audit matters to be communicated in the auditor's report and related discussions with the auditor and management.

Companies, including audit committees, also could spend additional time comparing their auditor's report to the auditors' reports of similar companies. Even though comparability regarding the pass/fail model will continue to be maintained, the communication of critical audit matters in the auditor's report that is specific to the audit of the company's current period financial statements would make the auditor's report less comparable among companies.

The communication of critical audit matters would result in differences among auditors' reports. For instance, the communication of critical audit matters is intended to

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<sup>81/</sup> See Sections V.B., *Determination of Critical Audit Matters*; V.D., *Communication in the Auditor's Report of Critical Audit Matters*; and V.E., *Documentation of Critical Audit Matters*, of this Appendix for discussion of recurring costs.



be tailored to the audit of the company; therefore, auditors' reports are not expected to be comparable from one auditor's report to the next. Such differences would relate to the auditor's determination of the matters that involved difficult judgments and difficulty in obtaining evidence or forming the opinion for a company based on that audit's particular facts and circumstances.

Company management and the audit committee might be concerned with the differences in auditors' reports because of investors' and other users' perceptions of the potential differences between the company's current period critical audit matters and those of prior periods or those of the company's competitors. However, investors have commented that they are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditors' reports among companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or Management's Discussion & Analysis ("MD&A") that is specific to a company or a reporting period.

2. *Potential Effects of Disclosing Information that Otherwise Would Not be Required to be Disclosed*

The proposed auditor reporting standard would require the auditor to describe in the auditor's report the considerations that led the auditor to determine that the matter is a critical audit matter, in addition to identifying the matter and referencing the matter to the relevant financial statement accounts and disclosures, when applicable. The description of the considerations regarding the critical audit matter could include information about the audit or the financial statements that otherwise would not be required to be disclosed by either the auditor or the company under existing auditor reporting standards or requirements of the applicable financial reporting framework.

For example, under the proposed auditor reporting standard, the auditor could determine that a matter met the definition of a critical audit matter because it involved the most difficult, subjective, or complex auditor judgments, and, therefore, would be communicated as a critical audit matter in the auditor's report. However, under existing auditor reporting standards or requirements of the applicable financial reporting framework, such matter would not otherwise be required to be disclosed. Examples of such occurrences that might result in the communication of a critical audit matter could include situations involving (1) a deficiency in internal control over financial reporting that was not otherwise determined to be a material weakness and therefore, not required to be disclosed by management or the auditor; (2) a difficult decision by the auditor regarding a company's ability to continue as a going concern even though the auditor's ultimate decision was that substantial doubt did not exist, and therefore, did not require reporting by the auditor; or (3) a loss contingency, for which there was

significant difficulty in obtaining audit evidence but that ultimately was decided by management and the auditor to not warrant disclosure by the company in the financial statements under existing financial reporting standards.

Although the Board is not seeking to constrain the information the auditor would communicate for critical audit matters under its proposal,<sup>82/</sup> it is seeking comments on whether there are potential issues raised by the auditor's reporting of information to investors as a result of communicating critical audit matters that otherwise would not have required disclosure under existing auditor and financial reporting standards.

### 3. *Liability Considerations*

Some commenters expressed concern that changes to the auditor's reporting model could result in increased liability for auditors and issuers. Liability may be imposed on auditors and issuers (as well as 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 Exchange Act, as well as various state law causes of action. In discussing their concerns regarding potential liability, a number of commenters raised particular aspects of the Board's concept release that they viewed as troublesome from a liability perspective. For example, some commenters were critical of the auditor providing a supplement to the auditor's report containing an open-ended analysis or a discussion that could result in the auditor providing new information regarding the company, independent of the company's own disclosures in its financial statements. Further, other commenters, while recognizing potential liability concerns, suggested that the Board take a balanced approach in its rulemaking related to changes to the auditor's report.

In developing its proposal for communication of critical audit matters, the Board has sought a balanced approach that would promote more informative reporting about the audit (1) in a focused way and (2) that would not fundamentally change the auditor's current role of attesting on information prepared by management. Under the proposed auditor reporting standard, the auditor would be communicating information about the audit, based on audit procedures the auditor performed. The proposed auditor reporting

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<sup>82/</sup> However, the proposed auditor reporting standard would provide that auditors should not use language that can be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for critical audit matters or the opinion on the financial statements. See further discussion regarding language in the auditor's communication of critical audit matters in Section V.D., *Communication in the Auditor's Report of Critical Audit Matters*, of this Appendix.

standard regarding critical audit matters would be guided by criteria and factors, rather than a separate free-form analysis. However, the determination of critical audit matters and the nature and extent of the communication in the auditor's report would be guided by the auditor's judgment, and the Board is not seeking to constrain the information the auditor would communicate for critical audit matters.<sup>83/</sup> The auditor's communication of critical audit matters would represent matters that have been addressed by the auditor in forming the opinion on the financial statements and is not intended to detract from, disclaim, or qualify the auditor's opinion.

The Board recognizes, however, that under its proposal, the auditor would be making new statements in the auditor's report that could raise potential liability concerns.

Questions Related to Section V:

10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?
11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?
12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?
13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?
14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?

15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?
16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?
17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?
18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?
19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?
20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?
21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?
22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?
23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?
24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an

auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?

25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?
26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.
27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?
28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?

**VI. Explanatory Language (Paragraphs 15 – 16 of the Proposed Auditor Reporting Standard)**

Under existing PCAOB standards certain circumstances require that the auditor add explanatory language (or an explanatory paragraph) to the auditor's report. The proposed auditor reporting standard references those circumstances. Additionally, the auditor may add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements.<sup>84/</sup> This type of explanatory paragraph is not required by the

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<sup>84/</sup> AU sec. 508.19 describes these types of explanatory paragraphs as "emphasis of a matter paragraphs" or "emphasis paragraphs."

proposed auditor reporting standard or other PCAOB standards. Explanatory language is added to the auditor's report to provide information about the financial statements or the audit without affecting the auditor's opinion on the financial statements. This approach is retained from existing AU sec. 508.<sup>85/</sup>

**A. Explanatory Language Required by Other PCAOB Standards (Paragraph 15 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard, similar to existing AU sec. 508,<sup>86/</sup> provides a list of circumstances in which the auditor is required to add explanatory language to the auditor's report and provides references to other PCAOB standards in which these circumstances and related reporting requirements are described. In certain circumstances, the auditor might communicate this information in a separate paragraph, called an explanatory paragraph.

The circumstances under which the auditor is required to add an explanatory language would occur, for example, when there is substantial doubt about the company's ability to continue as a going concern,<sup>87/</sup> when the auditor's opinion is based in part on the report of another auditor and the auditor decides to refer to that report,<sup>88/</sup> or when there has been a material change between periods in accounting principles or in the method of their application.<sup>89/</sup> The list of circumstances that require explanatory language can serve as a single reference source for auditors regarding when explanatory language is required in the auditor's report.

The proposed requirement to communicate critical audit matters does not alter the existing requirements to add explanatory language. However, a matter that requires explanatory language, such as a restatement, also might be a matter that involved the most difficult judgments or posed the most difficulty to the auditor in forming the opinion. Therefore, the same matter – the restatement in this case – would require an explanatory paragraph in the auditor's report in accordance with Auditing Standard No.

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<sup>85/</sup> See existing AU secs. 508.11 and .19.

<sup>86/</sup> See existing AU sec. 508.11.

<sup>87/</sup> See AU sec. 341.

<sup>88/</sup> See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

<sup>89/</sup> See Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.



6 and also would be communicated as a critical audit matter in accordance with the proposed auditor reporting standard. The auditor may include a cross-reference in the auditor's report as appropriate.

Further, recent academic literature finds that companies that receive unqualified audit reports containing explanatory language as described in AU sec. 508, such as a change between periods in accounting principles,<sup>90/</sup> are more likely to subsequently restate their financial statements.<sup>91/</sup> More specifically, the study states that audit reports with explanatory language could indicate a heightened risk of financial statement misstatement and that standard setters should be cautious to not require additional reporting without considering the potential of diluting information provided by currently required explanatory language in auditor reports.<sup>92/</sup> The proposed auditor reporting standard retains the provisions of AU sec. 508 with respect to explanatory language, such as a change between periods in accounting principles and stipulates that the communication of critical audit matters would be in addition to any explanatory language included in the auditor's report. Accordingly, the communication of critical audit matters is not intended to dilute the information that would be provided by the required explanatory language but would provide more information about the audit that might also be informative to investors and other financial statement users.

**B. Paragraphs to Emphasize a Matter Regarding the Financial Statements (Paragraph 16 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard retains from AU sec. 508 the ability for the auditor to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. Such explanatory paragraphs are currently used by auditors to emphasize (1) accounting matters, other than those involving a change in accounting principles, affecting the comparability of the financial statements and (2) other matters, such as the use of an accounting framework other than U.S. GAAP,

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<sup>90/</sup> Id.

<sup>91/</sup> See Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor 'Commentary' in Unqualified Audit Reports Reflect Financial Misstatement Risk?* Unpublished working paper (2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2245855](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245855).

<sup>92/</sup> Id.

litigation or regulatory matters, and certain fair value matters.<sup>93/</sup> Generally, an explanatory paragraph that emphasizes a matter in the financial statements points to a disclosure in the company's financial statements that discloses the matter without providing any further information.

Consistent with existing AU sec. 508, the proposed standard would not require the auditor to emphasize a matter but permits the auditor to add such explanatory paragraphs when the auditor determines that a matter presented or disclosed in the financial statements would be important to a user's understanding of the financial statements, such as a significant subsequent event.

The proposed requirement to communicate critical audit matters does not alter the auditor's ability to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. The auditor's communication of a critical audit matter may provide more information about the auditing aspect of the matter emphasized in the auditor's report.

Existing AU sec. 508 provides examples of matters the auditor may emphasize in the auditor's report.<sup>94/</sup> The proposed auditor reporting standard similarly provides a list of examples, which have been retained or enhanced from existing AU sec. 508, incorporates an additional example from the existing PCAOB standard,<sup>95/</sup> and adds new examples. While examples of potential matters that the auditor may emphasize in the auditor's report are provided in the proposed auditor reporting standard, the auditor also may decide to emphasize other matters in the financial statements if the auditor determines it is appropriate to do so.

Questions Related to Section VI:

29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?

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<sup>93/</sup> In the audit reports of approximately 7,000 issuers with fiscal year 2011 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 4.5% of the filings.

<sup>94/</sup> See existing AU sec. 508.19.

<sup>95/</sup> See paragraph .18 of AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410*.

30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?
31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?
32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?

## **VII. Amendments to Other PCAOB Standards**

The Board is proposing amendments to several of its existing auditing standards to conform to the proposed auditor reporting standard. Appendix 3 contains the proposed amendments to existing PCAOB auditing standards related to the proposed auditor reporting standard. Significant amendments are described below.

### **A. Amendments to Auditing Standard No. 5**

Auditing Standard No. 5 establishes requirements and provides direction when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

The Board is proposing to amend the auditor's report on internal control over financial reporting to include the following amendments to conform to the proposed auditor unqualified report:

- Conform certain required elements of the auditor's report on the audit of internal control over financial reporting<sup>96/</sup> to the auditor's report on the audit of the financial statements; and
- Amend the example combined report.<sup>97/</sup>

The proposed amendments to the required elements of the auditor's report on the audit of internal control over financial reporting, as well as to the example combined report, would require:

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<sup>96/</sup> See paragraph 85 of Auditing Standard No. 5.

<sup>97/</sup> See paragraph 87 of Auditing Standard No. 5.

- The title, "Report of Independent Registered Public Accounting Firm" (this title is included in the example combined report in Auditing Standard No. 5; however, the existing requirement in Auditing Standard No. 5 only specifies that the title include the word "independent");
- Addressees that include, but are not necessarily limited to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;
- Name of the company whose internal control over financial reporting was audited;
- Statement that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB; and
- Statement containing the year the auditor began serving consecutively as the company's auditor.

Since the statements regarding the auditor's requirement to be independent and the auditor tenure are included as the proposed basic elements of the auditor's unqualified report, they also might be useful to the users of the auditor's report on the audit of internal control over financial reporting.

Additionally, the example combined report in Auditing Standard No. 5 would include a section titled "The Auditor's Responsibilities Regarding Other Information" that includes the reporting requirements related to auditor's responsibilities regarding other information outside the audited financial statements and the results of the auditor's evaluation of the other information. In addition, the proposed auditor reporting standard states that if the auditor performs an audit of internal control over financial reporting that is integrated with an audit of the financial statements and chooses to issue a combined report, the paragraph in the auditor's report describing the auditor's responsibilities regarding other information should be updated to indicate that the auditor audited both the financial statements and the company's internal control.

## **B. Amendments to Auditing Standard No. 6**

Auditing Standard No. 6 establishes requirements for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements and the effect of that evaluation on the auditor's report. Auditing Standard No. 6 requires the auditor to include explanatory language in the auditor's report to recognize a change in accounting principle or a correction of a material

misstatement in previously issued financial statements if the change has a material effect on the financial statements.<sup>98/</sup> The related reporting requirements and illustrative paragraphs, however, are currently included in existing AU sec. 508.<sup>99/</sup>

The proposed auditor reporting standard would amend Auditing Standard No. 6 to include the reporting requirements and illustrative paragraphs from existing AU sec. 508.<sup>100/</sup> This change was made because, except for a few circumstances, the reporting requirements for explanatory language are contained in the respective standards requiring such reporting.

### **C. Amendments to Auditing Standard No. 7**

The proposed amendments to Auditing Standard No. 7 would require the engagement quality reviewer to evaluate whether appropriate critical audit matters are communicated in the auditor's report. The engagement quality reviewer's evaluation could be facilitated by the documentation requirement of the proposed auditor reporting standard. The proposed auditor reporting standard requires the audit documentation to include the determination of critical audit matters in accordance with Auditing Standard No. 3, which would require the auditor's documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters that would appear to meet the definition of a critical audit matter were not critical audit matters.

Auditing Standard No. 7 currently requires the engagement quality reviewer in an audit engagement "to evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report."<sup>101/</sup> Therefore, the engagement

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<sup>98/</sup> See paragraphs 5-10 of Auditing Standard No. 6.

<sup>99/</sup> See existing AU secs. 508.17A through .18C.

<sup>100/</sup> See existing AU secs. 508.17B-.17D and .18A-.18B and the proposed amendments to paragraphs 12 through 17 of Auditing Standard No. 6. In previous PCAOB standard-setting projects, the substance of current AU sec. 508.17A has been repeated in existing paragraphs 7 and 8 of Auditing Standard No. 6 and the substance of current AU sec. 508.18C has been placed in existing paragraph 10 of Auditing Standard No. 6. Therefore, the Board is proposing to supersede AU secs. 508.17A and .18C without corresponding changes to Auditing Standard No. 6.

<sup>101/</sup> See paragraph 9 of Auditing Standard No. 7.

quality reviewer is likely to discuss the matters determined to be critical audit matters with the engagement team. The proposed amendment would require the engagement quality reviewer to evaluate the engagement team's compliance with the requirements of the proposed auditor reporting standard regarding the auditor's communication of the critical audit matters.

**D. Amendments to Auditing Standard No. 16**

Auditing Standard No. 16 requires auditors to communicate certain significant audit and financial statement matters to the audit committee. Among other things, Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee matters related to departures from the auditor's unqualified report. Under the Board's existing standard, the auditor is required to communicate certain information when the auditor expects to (1) modify the opinion in the auditor's report and (2) include explanatory language or an explanatory paragraph in the auditor's report.<sup>102/</sup>

The proposed amendments to Auditing Standard No. 16 would delete the existing communication requirement regarding the auditor's report and would replace it with a requirement to provide to and discuss with the audit committee a draft of the auditor's report. Providing and discussing a draft of the report would inform the audit committee about the language in the audit report for tenure, critical audit matters, explanatory language (or explanatory paragraphs), and departures from an unqualified report. The proposed amendment to Auditing Standard No. 16, however, would not preclude the auditor from communicating with the audit committee any changes to the auditor's report prior to the preparation of the draft auditor's report.

**E. Amendment to AU sec. 336**

The proposed amendment to AU sec. 336, *Using the Work of a Specialist*, would enable the auditor to reference the use of a specialist in the auditor's report in connection with the auditor's communication of critical audit matters, if the auditor believes such reference will facilitate an understanding of the audit matter or the considerations that led the auditor to determine that the audit matter is a critical audit matter. Currently, existing AU sec. 336 states that the auditor should not refer to the work or findings of a specialist, except for situations in which the auditor decides to add explanatory language to his or her report or depart from an unqualified opinion.<sup>103/</sup> The proposed amendment is intended to explain that the auditor is not precluded from

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<sup>102/</sup> See paragraph 21 of Auditing Standard No. 16.

<sup>103/</sup> AU secs 336.15-.16.



referencing the specialist if the reference is related to a critical audit matter. Because of the statement in the auditor's report that communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole, the auditor's reference to the use of specialists should not be misunderstood as a qualification of the auditor's opinion or a division of responsibility.

**F. Amendments to Existing AU sec. 508**

The proposed auditor reporting standard would supersede portions of existing AU sec. 508 that primarily relate to an unqualified opinion.<sup>104/</sup> The remaining portions of existing AU sec. 508 primarily address departures from the auditor's unqualified report, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion. Accordingly, existing AU sec. 508 would be retitled from "Reports on Audited Financial Statements" to "Departures from Unqualified Opinions and Other Reporting Circumstances."

The proposed amendments to the remaining portions of AU sec. 508 are not intended to change the substance of the remaining provisions of AU sec. 508. The proposed amendments would primarily consist of (1) requiring the communication of critical audit matters in certain circumstances; (2) revising certain terminology to align with the proposed auditor reporting standard; and (3) amending the illustrative reports. Further updating and revision may be required to existing AU sec. 508, as amended by this proposal, which would be considered by the Board in a separate standard-setting project.

The proposed amendments to AU sec. 508 include:

1. *Communication of Critical Audit Matters in Opinions Other Than Unqualified*

*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 company in conformity with generally accepted accounting principles.<sup>105/</sup> Existing AU sec. 508 requires that when the auditor expresses a qualified opinion, he or she discloses all of the substantive reasons in a separate paragraph.

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<sup>104/</sup> AU secs. 508.01-.09 and .11-.19 would be superseded.

<sup>105/</sup> See AU sec. 508.20.

The proposed amendments would require that when the auditor expresses a qualified opinion, the auditor's report also include, among other things, communication of critical audit matters. The Board would expect in most circumstances that the reason for the qualification of the auditor's report would also give rise to a critical audit matter. In that case, the auditor may include a cross-reference in the auditor's report as appropriate. However, in such an audit, there may be other matters meeting the criteria of a critical audit matter; therefore, requiring the communication of critical audit matters would be considered appropriate.

### *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 generally accepted accounting principles.<sup>106/</sup> The existing requirements related to an adverse opinion were not amended to require the auditor to communicate critical audit matters. If the financial statements are not presented fairly, existing AU sec. 508 requires the auditor to explain the auditor's reason for the adverse opinion. Requiring the auditor to communicate additional critical audit matters was not considered necessary because the most important matter to investors and other financial statement users would be the reason for the adverse opinion.

### *Disclaimer of Opinion*

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.<sup>107/</sup> The existing requirements related to a disclaimer of an opinion were not amended to require the auditor to communicate critical audit matters because the auditor is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements. Because the auditor is not able to complete the audit and form an opinion on the financial statements, the auditor would not be able to determine the matters that involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty in obtaining sufficient appropriate audit evidence, or posed the most difficulty in forming the opinion on the financial statements.

## 2. *The Term "Explanatory Paragraph"*

Existing AU sec. 508 includes references to the term "explanatory paragraph" that describe the auditor's responsibility to provide the reason for a departure from an

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<sup>106/</sup> See AU sec. 508.58.

<sup>107/</sup> See AU sec. 508.61.

unqualified opinion. This term would be amended to "basis for departure from unqualified opinion paragraph" to differentiate this paragraph from an explanatory paragraph, as described in the proposed auditor reporting standard.

### 3. *Illustrative Reports*

Existing AU sec. 508 includes illustrative reports related to qualified opinions, adverse opinions, and disclaimers of an opinion. These reports would be amended to reflect the proposed basic elements of the auditor's unqualified report, as applicable in the particular reporting circumstances.

#### **G. Amendments to AU sec. 623**

AU sec. 623, *Special Reports*, includes the reporting requirements for various types of special reports, such as reports on specified elements, accounts, or items of a financial statement. Since many of these reports are not required to be filed with the SEC, the Board did not amend the illustrative reports included in AU sec. 623. However, a note is proposed to be added to AU sec. 623 indicating that if any of the reports are to be filed with the SEC, the auditor would include the basic elements of the auditor's unqualified opinion and critical audit matters as described in paragraphs 6 and 7-14, respectively, of the proposed auditor reporting standard. For qualified, adverse, and disclaimer of opinion reports, AU sec. 623 also would be amended to include a reference to the requirements of AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

#### **H. Other Amendments**

The proposed amendments to other PCAOB standards primarily relate to:

- Updating references as a result of auditing standards that are being amended or superseded. For example, for references in the auditing standards to AU sec. 508, the proposed amendment would change the title from "Reports on Audited Financial Statements" to "Departures from Unqualified Opinions and Other Reporting Circumstances;"
- Updating illustrative reports for the basic elements of the proposed auditor reporting standard for the reports that are filed with the SEC. For example, updating the example report in AU sec. 543 that illustrates appropriate reporting by the principal auditor indicating the division of responsibility when the auditor makes reference to the audit of the other auditor; and
- Updating AU sec. 722, *Interim Financial Information*, for the basic elements of the proposed auditor reporting standard.

Questions Related to Section VII:

33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?
34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.

**VIII. Considerations Related to Audits of Specific Entities**

The Board is seeking comment on the applicability of the proposed auditor reporting standard and amendments to the audits of specific entities, including brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans.

**A. Brokers and Dealers**

*1. Background Information*

As Exchange Act Rule 17a-5 ("Rule 17a-5") requires that audits of brokers and dealers be conducted in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014,<sup>108/</sup> the proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits. At the publication date of the Board's proposal, the final SEC rules have not been published in the Federal Register.

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators annual audited financial statements.<sup>109/</sup> All of the statements contained in the annual audited financial statements of the broker or dealer are public, except that if the statement of financial condition is bound separately from the balance of the annual audited financial statements, the balance of the annual

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<sup>108/</sup> See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>. Citations in this Section are to SEC Rule 17a-5 under the Exchange Act, as revised in Exchange Act Release No. 70073.

<sup>109/</sup> See SEC Rule 17a-5 of the Exchange Act, 17 C.F.R. § 240.17a-5.

audited financial statements is deemed confidential and thus available for use only by the SEC and others to whom the SEC gives authorization.<sup>110/</sup> Therefore, in situations in which the broker or dealer binds separately the statement of financial condition from the balance of the annual audited financial statements, the auditor generally would issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete audited financial statements that, along with the audited financial statements, would be confidential and not available to the public.<sup>111/</sup>

There were approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012.<sup>112/</sup> Based on research conducted by the PCAOB's Office of Research and Analysis ("ORA"), approximately 45% of these brokers and dealers filed a statement of financial condition that was bound separately from the balance of the annual audited financial statements. For those brokers and dealers, only the statement of financial condition, with the related auditor's report, is publicly available, while the complete annual audited financial statements, with the related auditor's report, are confidential. For the remaining 55% of the population of brokers and dealers, the complete annual audited financial statements and the related auditor's report are publicly available.<sup>113/</sup>

ORA's research also indicates that there are no issuers among the approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012. Approximately 9% of the 4,230 brokers and dealers are subsidiaries of issuers. The remainder are not owned by issuers.

According to ORA's research, for the population of brokers and dealers that are not subsidiaries of issuers (1) approximately 90% are directly owned by an individual or an entity that owns more than 50% of the broker or dealer and (2) approximately 75% have five or fewer direct owners. A review of the title or status of the brokers' or dealers'

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<sup>110/</sup> See SEC Rule 17a-5(e).

<sup>111/</sup> See also SEC Rule 17a-5(c)(2) regarding audited statements required to be provided to customers.

<sup>112/</sup> This information is based on the number of brokers and dealers that filed annual audited financial statements with the SEC through May 1, 2013 for fiscal periods ended during 2012.

<sup>113/</sup> ORA obtained information from the SEC's EDGAR database on brokers and dealers that filed public and confidential annual audit reports with the SEC.

direct owners who are individuals suggests that these owners are generally part of the broker's or dealer's management.

In summary, ORA's research indicates that ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team.

## 2. *Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of brokers and dealers. Many commenters who responded to this question in the concept release supported requiring the same reporting for all companies.

The Board received additional comments that were specific to audits of brokers and dealers from a small number of commenters. Some of those commenters suggested that the Board take into account the special characteristics of brokers and dealers in considering whether the changes to the auditor's report should apply to audits of brokers and dealers. Other commenters thought that certain changes, for example clarifications to language in the auditor's report, may be applicable to auditors' reports for brokers and dealers, but other changes to the auditor's report should not apply to audits of brokers and dealers. One commenter on the concept release noted that amendments to Rule 17a-5 proposed by the SEC would provide users of brokers' and dealers' financial statements with sufficient information that would make additional auditor reporting unnecessary.

## **B. Investment Companies**

### 1. *Background Information*

The proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to the audits of investment companies. The Investment Company Act of 1940 ("Investment Company Act") generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.<sup>114/</sup> Investment companies registered with the SEC under the Investment Company Act are required to file with the SEC, on Form N-CSR, annual reports containing audited financial statements.<sup>115/</sup>

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<sup>114/</sup> See Section 3(a)(1) of the Investment Company Act.

<sup>115/</sup> See SEC Rules under Section 30(e) of the Investment Company Act.



An investment company (1) is generally organized by an outside "sponsor" (also known as promoter<sup>116/</sup>), such as a bank or an insurance company and (2) has an investment adviser,<sup>117/</sup> which manages the investment company's portfolio securities for a fee. A sponsor might register many investment companies that generally would have the same or related investment advisers. Such investment companies are referred to as affiliated. Annual shareholder reports of affiliated investment companies that have the same fiscal year-end might be filed with the SEC in one Form N-CSR. This document generally contains a single auditor's report that refers to the financial statements of each audited investment company. The financial statements of the affiliated investment companies might contain some disclosures that would be similar across the affiliated investment companies, such as the management fee arrangements, because of the common investment adviser. Other disclosures might be different, such as disclosures related to the use of derivatives, because of the different investment strategies of each investment company.

Investment companies can also be part of master-feeder or fund of funds capital structures.<sup>118/</sup> In master-feeder structures, feeder investment companies invest all their assets in another investment company, known as the master fund, and own proportionate shares of the net assets of the master fund. Master-feeder accounting involves allocating the master's income, expenses, and realized and unrealized gains and losses among the feeder funds. Additionally, accounting policies of the master fund, such as valuation of investments of the master fund, may affect the feeder funds. A master and feeder fund may not be affiliated, may have different auditors, and different fiscal year ends. As described in SEC staff guidance, the annual report of each feeder fund generally contains the financial statements of both the master and the feeder fund.<sup>119/</sup>

Funds of funds are investment companies that invest in other investment companies. A fund of funds' structure is similar to that of a master-feeder, except that it

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<sup>116/</sup> See Section 2(a)(30) of the Investment Company Act.

<sup>117/</sup> See Section 2(a)(20) of the Investment Company Act.

<sup>118/</sup> See Section 12(d)(1) of the Investment Company Act, which describes investment companies involved in such structures as acquiring company and acquired company.

<sup>119/</sup> See SEC "Dear CFO" letters at <http://www.sec.gov/divisions/investment/noaction/1997/cfo110797.pdf> and <http://www.sec.gov/divisions/investment/noaction/1995/accountingcomment110295.pdf>.

generally invests its assets in more than one other fund. Because of certain limitations under the Investment Company Act,<sup>120/</sup> an issuer fund of funds and the investee funds are often affiliated, but may have different auditors and fiscal year ends.

In January 2009, the SEC adopted amendments to Form N-1A that require every open-end management investment company prospectus to include a summary section consisting of key information about the investment company.<sup>121/</sup> The SEC described these amendments as intended to help investors to access key information that is important to an informed investment decision.<sup>122/</sup> In describing the rationale for the adopted amendments, the SEC stated that there was consensus among roundtable participants and other commenters that the key information that investors need to make an investment decision about an investment company includes information about the investment company's investment objectives and strategies, risks, costs, and performance.<sup>123/</sup> The investment company's costs and performance calculations are subject to audit and are included in the financial highlights, which are referred to in the auditor's report.

## 2. *Consideration of Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of investment companies. Many commenters who responded to this question of the concept release supported requiring the same reporting for all companies.

The Board received comments that were specific to audits of investment companies from a small number of commenters. Those commenters generally expressed the view that additional auditor reporting should not apply to audits of investment companies. These commenters viewed investment companies' financial

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<sup>120/</sup> See Section 12(d)(1) of the Investment Company Act.

<sup>121/</sup> See SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 8998 (Jan. 13, 2009), at 7.

<sup>122/</sup> See SEC Release No. 8998, at 14-15.

<sup>123/</sup> See SEC Release No. 8998, at 9-11. See also ICI, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006), at 2-3, available at [http://www.ici.org/pdf/rpt\\_06\\_inv\\_prefs\\_full.pdf](http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf).

statements as inherently less complex than operating companies' financial statements and argued that the limited nature of an investment company's operations entails fewer estimates and judgments.

## **C. Employee Stock Purchase, Savings, and Similar Plans**

### *1. Background Information*

The proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to the audits of employee stock purchase, savings, and similar plans ("benefit plans"). Benefit plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K<sup>124/</sup> that includes the benefit plan's audited financial statements and the related auditor's report.<sup>125/</sup> The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.<sup>126/</sup>

In general, the primary objective of the financial statements of a benefit plan is to provide information about the plan's assets, liabilities, and ability to pay benefits. Defined-contribution benefit plan participants do not invest directly in a benefit plan; rather they select their investments outside of the benefit plan, with the plan holding the investments as its assets.

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<sup>124/</sup> See Section 15(d) of 1934 Act.

<sup>125/</sup> A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. See SEC Rule 15d-21, C.F.R §240.15d-21.

<sup>126/</sup> See FASB ASC 960-10-05-6. Benefit plans subject to ERISA also file with the DOL an annual report on form 5500, including audited financial statements and an auditor's report. Pursuant to DOL requirements, the audit of the financial statements is performed under auditing standards generally accepted in the U.S., that is, not under PCAOB standards. ERISA-related information is available at the DOL website at [http://www.dol.gov/compliance/laws/comp-erisa.htm#applicable\\_laws](http://www.dol.gov/compliance/laws/comp-erisa.htm#applicable_laws).

2. *Consideration of Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC. Many commenters who responded to this question of the concept release supported requiring the same reporting for all companies.

The Board received comments that were specific to audits of benefit plans from a small number of commenters. One commenter thought the Board should proceed with caution regarding employee benefit plans that file a Form 11-K. Another commenter said that users of pension plans' financial statements are not requesting or in need of an expanded auditor reporting model.

Questions Related to Section VIII:

35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?
36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? If not, why not?
37. Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?
38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?
39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?

40. Should audits of certain companies<sup>127/</sup> be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?

**IX. Considerations Related to Effective Date**

The proposed auditor reporting standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposal as well as the timing of Board adoption of any final standard and amendments. Additionally, some commenters suggested that, depending on the extent of changes to the auditor's report, the Board consider a delayed compliance date depending on the size of the company. The Board is seeking comment on whether any special consideration should be given to a delayed compliance date for the proposed auditor reporting standard, such as for the audits of smaller companies.

Questions Related to Section X:

41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?
42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

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<sup>127/</sup> See Appendix 7 for a discussion on costs and other considerations related to EGCs.

## **Exhibit – Illustrative Examples of Critical Audit Matters**

This Exhibit contains three illustrative examples of communications of critical audit matters in an auditor's report. Each of the three illustrative examples contain background information, the company's related notes to the financial statements, determination of the critical audit matter, and the communication of the critical audit matter as it would appear in the auditor's report.

All three examples are based on hypothetical situations and have been prepared for illustrative purposes only. They are not intended to provide guidance or any suggestions regarding the accounting or disclosure required, nor any implied audit procedures, in the circumstances presented.

### **A. Hypothetical Auditing Scenario #1 – Allowance for Sales Returns**

#### *1. Background*

In the year ended January 31, 2013 ("fiscal 2013"), an established brick-and-mortar retail company ABC Retailer ("ABC" or the "Company") implements a strategic decision to expand its product offerings concurrent with developing a significant on-line sales channel. Simultaneously, it lengthens its existing 30-day sales returns policy to 60 days. This change in returns policy, along with the expanded product offerings and new on-line presence, are announced in a fiscal 2013 advertising campaign.

ABC's management projects a significant increase in sales and an increase in returns in fiscal 2013 as a result of these changes. The Company designs and implements new or enhanced procedures, processes, and systems during fiscal 2013 to address the product expansion, the on-line distribution channel, and the expected increase in customer returns.

ABC has significant historical experience to estimate sales allowances based on its traditional products and sales channel. Because of the strategic changes and longer sales return period, management performs an in-depth analysis of how changes in product mix, customer demographics, and the use of on-line "stores" to sell merchandise are likely to affect historical experience in sales returns. Management uses industry data and other sources, including the results of its own market research, to perform this analysis. Management also implements new systems to improve the identification, processing, and tracking of sales returns and develops a statistical model to estimate future returns. The statistical model relies on a number of inputs and assumptions derived from the sales return tracking system. As a result, management believes its historical experience in combination with the new systems and statistical model allow management to make reasonable estimates of sales returns for fiscal 2013.



During fiscal 2013, ABC's management decides to significantly lengthen the 60-day returns policy without publicly announcing a change to the stated policy. In response to on-line customer complaints about the Company's returns policy in the past, full refunds are given "no questions asked" for returns within 90 days and in specific circumstances for returns within 120 days. To reflect the lengthened sales returns policy, management makes adjustments to the sales returns allowance determined by the statistical model. These adjustments are partly based on data generated by the sales returns tracking system and partly based on management's judgment about how recent sales activity and other factors such as seasonality, recent promotions, and the nature and frequency of customer complaints are affecting ABC's application of its stated sales returns policy. Disclosure of management's actions regarding its sales returns policy was made in the MD&A.

2. *Excerpts From the Company's Notes to the Financial Statements*<sup>128/</sup>

**Note 1: Accounting Policies**

**Revenue Recognition**

We recognize revenue when the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the selling price is fixed or determinable; and collectability is reasonably assured. For sales made at our retail stores, we generally recognize revenue at the time of a sale to a customer. For sales made through our website, we generally recognize revenue at the time the merchandise is shipped to a customer. As part of our customer service strategy, we offer customers the right to return undamaged merchandise for a full refund if they are not satisfied with their purchase. We record an allowance for estimated returns as a reduction of gross revenues and cost of goods sold, and as an accrued current liability based on historical experience and trends. If we are unable to make reasonable estimates of future returns, revenue is deferred until the return period expires. In fiscal 2011, 2012, and 2013, no revenues were deferred due to an inability to make reasonable estimates of future returns.

Beginning in fiscal 2013, we use a statistical model that utilizes our historical experience to estimate future returns. Inputs and assumptions to our model include, among other factors: historical experience based on sales of similar products; the

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<sup>128/</sup> Only financial statement information relating to the disclosure and determination of the revenue recognition relative to the allowance for sales returns is presented. Other required notes to the financial statements have been omitted from this example.

relative risk of returns based on the nature of the product, such as susceptibility to changes in technology or changes in demand due to new product introductions; historical data related to the effect that special promotions and/or seasonality has on returns; and the relative risk of returns based on the selling price of the merchandise and the sales channel that the customer used to make a purchase. We also incorporate expected changes, if any, in our returns policies and practices as well as changes in economic and buying trends that might impact customer demand and behavior. If actual returns are not consistent with our estimates, we factor the new information into our statistical model and adjust our previous estimate in the period new information becomes available.

### 3. *Determination of the Critical Audit Matter*

The auditor determined that the evaluation of the allowance for sales returns is a critical audit matter in the audit of ABC's fiscal 2013 financial statements.

Specific considerations, which led the auditor to determine that the auditor's evaluation of the allowance for sales returns is a critical audit matter, included:

- Extensive changes to the Company's business strategy, including changes to the Company's distribution channel through the use of on-line "stores" to sell merchandise;
- Significant lengthening of the Company's sales return policy (from 30 to 60 days) and flexible application of it (90 – 120 days);
- The development of a new statistical model to estimate future sales returns, which included management adjustments to the statistical model to reflect the flexible application of the sales return policy;
- Significant increase in the Company's expected sales returns;
- The extensive amount of consultation with the audit firm's national office regarding the design of appropriate audit procedures, evaluation of the results of those procedures, and assessment of compliance with U.S. GAAP relative to the audit of the allowance for sales returns;
- The significant difficulty in obtaining sufficient appropriate audit evidence to support management's subjective adjustments to the allowance computed by the statistical model; and
- The complexity and difficulty of evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns.

4. *Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

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

We determined that our evaluation of the Company's allowance for sales returns was a critical audit matter in the audit of the Company's financial statements as of and for the fiscal year ended January 31, 2013. The Company developed a new on-line sales channel. This new sales channel could have significantly different return experience than sales through its more established retail stores. In addition, the Company simultaneously lengthened its return policy. The Company developed new models with different assumptions to reflect these changes in its estimate of the allowance for sales returns, a key element in recording revenue. The lack of historical experience with the new assumptions resulted in a high degree of measurement uncertainty in estimating the allowance for sales returns.

Because of these changes in the Company's distribution channel and sales return policy, our audit of the Company's allowance for sales returns (1) involved our difficult and subjective judgments in evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns and (2) posed difficulty to us in obtaining sufficient appropriate evidence to support management's adjustments to the allowance for sales returns. We consulted with our national office on (1) the design and performance of audit procedures to test the data underlying management's assumptions used to estimate future sales returns and (2) our evaluation of the results of those procedures, including our assessment of the reasonableness of management's judgments regarding the effect that changes in the Company's return policies and practices, as well as changes in economic and buying trends that affect customer behavior, have on the estimate of future sales returns. The Company's accounting policy for sales returns is discussed in Note 1 to the financial statements.

**B. Hypothetical Auditing Scenario #2 – Valuation Allowance for Deferred Tax Assets**

*1. Background*

As of the year ended June 30, 2013 ("fiscal 2013"), XYZ Technology Company ("XYZ" or the "Company") has been in business for 10 years. In its first three years, as its "first generation" products were being developed and commercialized, the Company incurred losses for both financial reporting and federal income tax purposes. For income tax purposes, the losses are carried forward and subsequently utilized to reduce federal income taxes that otherwise would have been payable. By its sixth year of operations, XYZ is profitable for tax purposes, has no remaining net operating loss carryforwards, and has repaid its borrowings. Cash flows from operations are strong.

By fiscal 2010 (its seventh year of operations), competition begins to erode the Company's market share. XYZ reports breakeven results for financial reporting purposes and a small loss for income tax purposes in fiscal 2010. The loss is carried back for income tax purposes. The Company returns to profitability in fiscal 2011 by carefully controlling costs and by offering some "add-ons" to its "first generation" products that boost revenues.

During fiscal 2012 (its ninth year of operations), XYZ raises equity capital to provide additional liquidity for its ongoing development of "next generation" products (targeted to be introduced in fiscal 2014-2015). Due to the significant increase in development costs combined with continuing pressure on sales prices and unexpected cost increases in a critical component, XYZ reports a loss for both financial reporting and federal income tax purposes in fiscal 2012. A portion of the loss in fiscal 2012 creates a net operating loss carryforward. The Company's cash position remains strong.

During the year ended June 30, 2013, XYZ recalls one of its products due to a defect in a component supplied by a third party. Although the supplier is contractually obligated to reimburse the Company for the costs to recall and repair the defective products, the supplier disputes the role its component played in the product failure that led to the recall. Product development and marketing costs increase in preparation for the targeted 2014-2015 introduction of the "next generation" products. Additionally, costs are incurred (1) to exit certain unprofitable, peripheral product lines that are no longer consistent with XYZ's strategy and (2) to relocate its corporate office. The Company is able to somewhat mitigate the fiscal 2012 cost increase in a critical component but does not expect the cost of the component to return to historic levels in the near term.

As a result of these various circumstances, the Company incurs a significant pre-tax loss in the year ended June 30, 2013, for both financial reporting and federal income

tax purposes. In combination with other book-tax differences and the net operating loss carryforward from fiscal 2012, XYZ reports net deferred tax assets as of June 30, 2013.

As required by U.S. GAAP, management evaluates whether the recorded amount of deferred tax assets as of June 30, 2013 is realizable. In evaluating the need for a valuation allowance, management evaluates both negative and positive evidence to determine whether it is more likely than not that its deferred tax assets will be realized. From management's perspective, negative evidence includes losses in 2013 and 2012. However, management determined that it has not incurred cumulative losses in recent years<sup>129/</sup> when evaluated over a three-year time frame.<sup>130/</sup> Management's positive evidence includes the Company's historical ability to utilize operating loss carryforwards, a 15-year carryforward period, and a forecast of increased revenues and profits in the next three years. That forecast includes the following expectations: (1) favorable settlement with the supplier related to the recall; (2) elimination of certain unprofitable, peripheral product lines; (3) decline in the level of product development spending; and (4) commercialization of the "next generation" products.

Management also considers that some of the current year loss is the result of the product recall, the exiting of certain product lines, and the relocation of the corporate office, events that are not expected to recur in the future. Further, management considers XYZ's strong cash position. Lastly, management does not identify any qualifying tax-planning strategies. Based on the weight of all available evidence, both positive and negative, management concludes that no valuation allowance is required.

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<sup>129/</sup> See FASB ASC paragraph 740-10-30-16 through 30-24, *Income Taxes – Overall – Initial Measurement – Establishment of a Valuation Allowance for Deferred Tax Assets*, for the accounting requirements of a valuation allowance for deferred income tax assets including discussion regarding "cumulative losses in recent years."

<sup>130/</sup> ASC Topic 740-10-30-23 indicates that "[a]n entity shall use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome."

2. *Excerpts From the Company's Notes to the Financial Statements*<sup>131/</sup>

**Note 2: Accounting Policies**

**Income Taxes**

We account for income taxes under the asset and liability method. Deferred taxes are determined based on the temporary differences between the financial statement and tax basis of existing assets and liabilities using tax rates that under current tax law would be in effect in the years in which the differences are expected to reverse. The effect of a change in tax rates on deferred taxes is recognized in the period that includes the enactment date.

We make judgments regarding the realizability of our deferred tax assets. We consider our deferred tax assets to be realizable when we believe it is more likely than not that we will generate sufficient future taxable income to realize our deferred tax assets after consideration of all available evidence. We record a valuation allowance to reduce our deferred tax assets to the amount that we believe more than 50 percent likely to be realized. In assessing the need for a valuation allowance, we consider all positive and negative evidence, including the expected timing of reversals of existing temporary differences, projected future taxable income, tax planning strategies, and recent financial performance. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is generally a significant piece of negative evidence that is difficult to overcome in determining that a valuation allowance is not needed.

**Note 12: Income Taxes**

As of June 30, 2013, our deferred tax asset of \$XXX million related to federal net operating loss carryforwards will expire in approximately 14 to 15 years if not utilized. The determination of whether it is more than 50 percent likely that we will realize the full benefit of all our deferred tax assets, including the deferred tax asset related to the net operating loss carryforwards, requires significant judgment. That judgment includes evaluation of negative evidence, such as recent losses, and positive evidence, including projections of future taxable income during the carryforward period. As required by the accounting literature, more weight is given to objective evidence. Negative objective

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<sup>131/</sup> Only financial statement information relating to the disclosure and determination of deferred tax assets is presented. Other required notes to the financial statements have been omitted from this example.



evidence includes our losses in 2013 and 2012. However, we do not have cumulative losses in recent years when evaluated over a three-year time frame. Positive objective evidence that we considered in making our judgment included: (1) the effect of eliminating certain product lines and (2) the expectation that product recall costs and relocation costs will not recur in the future. Projections of future taxable income are subject to uncertainty due to various factors, including the general economic environment, industry and competitive conditions, timing of product enhancements and new product introductions, and the length of time of the projections included in the analyses. If our actual results are less favorable than current estimates and we revise our projections downward in future analyses, a valuation allowance may be required with a corresponding adjustment to earnings in the period in which such determination is made. As of June 30, 2013, based upon our estimates, we believe it is more likely than not that the Company will realize the full benefit of the existing deferred tax assets.

3. *Determination of the Critical Audit Matter*

The auditor determined that its assessment of management's evaluation of the realizability of deferred taxes is a critical audit matter.

Specific considerations, which led the auditor to determine that its assessment of management's evaluation of the realizability of deferred taxes is a critical audit matter, included:

- The auditor's prior experience with management's forecasts of future revenues and costs, which indicated that actual revenues and income typically differed from forecasted amounts;
- The subjectivity involved in evaluating whether the weight of the Company's positive evidence is sufficient to overcome the negative evidence;
- The extensive amount of consultations with the firm's National Office regarding: (a) the design and evaluation of the results of its audit procedures related to management's forecasts of improved profitability; (b) the appropriate application of the criteria under U.S. GAAP for recording a valuation allowance; (c) the assessment of management's judgments regarding the identification and evaluation of negative and positive evidence; and (d) the adequacy of XYZ's disclosure regarding risks and uncertainties that could significantly affect deferred tax assets in the near term; and
- High degree of difficulty auditing management's forecast of future revenues and income due to significant difficulty in obtaining objective

evidence to support management's key judgments about (1) the timing, demand and pricing of "next generation" products, (2) the ongoing demand for (and the life cycle of) existing products, (3) the level of future development spending, (4) the amount of marketing costs associated with the commercialization of new products, (5) the outcome of the supplier dispute regarding recall costs, and (6) future cost increases or decreases in the cost of critical components.

4. *Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

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

We determined that our assessment of the Company's evaluation of the realizability of deferred tax assets was a critical audit matter in the audit of the Company's financial statements for the fiscal year ended June 30, 2013. Considerations that led to our determination, included the following:

- The Company exercised significant judgment in weighing positive and negative evidence regarding the realizability of the company's deferred tax assets, including in developing forecasts of projected future taxable income.
- The Company continues to experience increased competition with its "first generation" products which reduced revenue growth, sales prices and profitability. Further, the Company experienced an unexpected cost increase in a critical product component and does not anticipate that cost returning to historical levels;
- A return to profitability by the Company is dependent upon launching "next generation" products in the future; and
- The Company is experiencing increases in product development and marketing costs in preparation for its "next generation" products.

Because of these considerations, our assessment of the Company's evaluation of the realizability of deferred tax assets: (1) involved subjective auditor judgments in evaluating whether management's judgments regarding the weight given to positive and negative evidence is appropriate; (2) involved difficult auditor judgments in designing audit procedures to test the data underlying management's forecasts of its future taxable income; (3) posed difficulty in obtaining sufficient appropriate evidence to support management's forecasts of the timing and amount of future taxable income due to the lack of objective evidence; and (4) posed difficulty in forming an opinion on the financial statements because of the significance to the financial statements, taken as a whole, of the Company's determination regarding the recognition of a valuation allowance for its deferred tax assets.

We consulted with others outside the engagement team regarding: (1) compliance with U.S. GAAP; (2) the design and performance of audit procedures to test management's forecasts; and (3) our evaluation of the results of those procedures, including our assessment of the reasonableness of management's judgments and forecasts in light of independent assessments of future trends in the industry, analyst reports and publicly available information regarding relevant trends by key competitors. The Company's accounting policy for deferred taxes and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12 to the financial statements.

**C. Hypothetical Auditing Scenario #3 – Fair Value of Fixed Maturity Securities Held as Investments That are Not Actively Traded**

*1. Background*

JLE Financial Institution ("JLE" or the "Company") holds fixed maturity securities in its investment portfolio. As of December 31, 2012 ("fiscal 2012"), the Company's investment portfolio includes U.S. corporate and state and local government securities. In addition, approximately 35% of the portfolio consists of private label mortgage-backed securities and collateralized loan obligations, which have very little or no trading activity. All of these securities are classified as "available for sale" and reported at fair value in the Company's statement of financial position under U.S. GAAP.

In measuring the fair value of available for sale securities, the Company utilizes third party pricing services for its U.S. corporate and state and local government securities. JLE's process requires that it obtain an understanding of the pricing service's valuation techniques, assumptions, and other inputs important to the fair value estimate. Further, JLE has controls over information received from third party pricing services.

The process to determine the fair value of the Company's private label mortgage-backed securities and collateralized loan obligations valued primarily using in-house

valuation models involves a significant amount of judgment, in large part because of the inherent imprecision in measuring the fair value of securities for which observable market prices are not available and the subjective nature of some of the inputs to the valuation model. In testing JLE's controls related to fair value estimates determined by in-house valuation models the auditor noted a control deficiency less severe than a material weakness relating to the controls employed by the pricing and valuation committee. As a result of the control deficiency, the auditor expanded the planned audit procedures for securities for which the control applied. In performing additional audit procedures on the population of securities for which the control applied, the auditor identified several misstatements due to JLE's recorded amounts falling outside of the range of reasonable estimates developed by the auditor's specialist.

2. *Excerpts From the Company's Notes to the Financial Statements*<sup>132/</sup>

**Note 6: Fair Value**

**Recurring Fair Value Measurements**

When observable inputs are not available, JLE's valuation methodologies rely on inputs that are significant to the estimated fair value that are not observable in the market or cannot be derived principally from, or corroborated by, observable market data. These unobservable inputs can be based in large part on management's judgment or estimation and cannot be supported by reference to recent market activity. Even though these inputs are unobservable, management believes they are consistent with what other market participants would use when pricing such securities and are considered appropriate given the circumstances. Securities that are valued using significant unobservable inputs or assumptions are classified as Level 3 in the fair value hierarchy.

While JLE believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. During fiscal 2012, there were no changes to the valuation techniques that had a material impact on the Company's consolidated financial position or results of operations.

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<sup>132/</sup> Only financial statement information relating to the disclosure and determination of the fair value of Level 3 fixed maturity investment securities is presented. Other required notes to the financial statements have been omitted from this example.

*U.S. corporate securities*

Valuations are based primarily on matrix pricing or other similar techniques that utilize observable inputs that are derived from, or corroborated by, observable market data, including quoted prices for identical or similar securities. In other cases, valuation is based primarily on quoted prices for identical or similar securities.

*State and local government securities*

These securities are principally valued using the market approach. Valuation is based primarily on matrix pricing using market observable inputs, including benchmark U.S. Treasury yields or other yields, issuer ratings, broker-dealer quotes, credit spreads and reported trades of similar securities.

*Private label mortgage-backed securities and collateralized loan obligations*

Valuation is based on in-house valuation models, discounted cash flow methodologies, or other techniques that utilize inputs that cannot be derived from, or corroborated by, currently observable data, including credit spreads that reflect specific credit-related issues. The pricing and valuation committee review the inputs used for each security for which the fair value is determined based on in-house valuation models.

3. *Determination of the Critical Audit Matter*

The auditor determined that the evaluation of management's fair value estimates of private label mortgage-backed securities and collateralized loan obligations measured using valuation models, is a critical audit matter.

Specific considerations, which led the auditor to determine that evaluation of management's fair value estimates of these securities, measured using valuation models, is a critical audit matter, included:

- The materiality of the private label mortgage-backed securities and collateralized loan obligations;
- The valuation techniques used to estimate the fair value of these securities which were based primarily on in-house models to estimate fair value;
- The control deficiency relating to the review by the pricing and valuation committee;

- The highly subjective nature of the judgments involved regarding unobservable inputs to the fair value measurements for these securities;
- The extensive amount of audit work required to obtain sufficient appropriate evidence to form a conclusion, including significant involvement of senior members of the engagement team;
- The use by the auditor of the work of a third party specialist with expertise in the valuation of complex financial instruments to develop independent estimates of fair value for corroborative purposes;
- The auditor's expansion of the planned audit procedures relating to the valuation of the mortgage-backed securities and collateralized loan portfolio as a result of contradictory evidence obtained from those audit procedures; and
- The auditor's proposed adjustments to the valuation of the mortgage-backed securities and collateralized loan obligations.

#### 4. *Communication of Critical Audit Matter in the Auditor's Report*

##### Critical Audit Matter

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

Approximately 35% of the Company's investment portfolio is comprised of private label mortgage-backed securities and collateralized loan obligations. Our audit of the Company's fair value of these securities in the audit of the Company's financial statements as of and for the fiscal year ended December 31, 2012 involved difficult and complex auditor judgments because these securities (1) trade less frequently and (2) were valued using in-house valuation models based on unobservable inputs, which are subject to a wide range of measurement uncertainty. Our audit of these securities required an extensive amount of audit work, including significant involvement of senior members of the engagement team and the involvement of a third party valuation specialist. Further, it was necessary to expand the planned audit procedures due to a control deficiency less severe than a material weakness noted in the Company's internal



control system regarding fair value estimates, valued using in-house valuation models. Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee. Our audit procedures resulted in our identification of several misstatements that were corrected by the Company. The Company's disclosures related to nature and fair values of these securities and the methods the Company used to determine those fair values are in Note 6 to the financial statements.

## **APPENDIX 6**

### ***Additional Discussion of the Proposed Other Information Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release***

This Appendix discusses the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"), presented in Appendix 2, and the related proposed amendments to certain PCAOB auditing standards (the "proposed amendments") presented in Appendix 4. This Appendix collectively refers to the proposed other information standard and proposed amendments as the "proposed other information standard and amendments." The proposed other information standard would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, and AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*.

Following the Board's initial outreach from October 2010 through March 2011,<sup>1/</sup> the Board issued on June 21, 2011 a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").<sup>2/</sup> Additionally, the Board held a public roundtable<sup>3/</sup> on the concept release and changing the auditor's report was discussed at the Board's Investor Advisory Group ("IAG")<sup>4/</sup> and Standing

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<sup>1/</sup> See Section II., *Board Outreach*, of the Release for further discussion regarding the Board's outreach.

<sup>2/</sup> *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-003 (June 21, 2011) is available at [http://pcaobus.org/Rules/Rulemaking/Docket034/Concept\\_Release.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf).

<sup>3/</sup> A transcript of the public roundtable is available at [http://pcaobus.org/Rules/Rulemaking/Docket034/09152011\\_Roundtable\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf).

<sup>4/</sup> IAG meeting details and webcasts for March 2011 and 2012 are available at [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx) and [http://pcaobus.org/News/Webcasts/Pages/03282012\\_IAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/03282012_IAGMeeting.aspx).

Advisory Group ("SAG") meetings.<sup>5/</sup> Some commenters supported changes to the auditor's report that describe the auditor's existing responsibility related to information outside the financial statements to inform investors and other financial statement users of the extent of the auditor's responsibility for other information contained in a document that also contains the financial statements and the related auditor's report.

This Appendix discusses significant comments received during the Board's outreach regarding other information in documents containing audited financial statements and the auditor's report. It also provides additional background information regarding the requirements in the proposed other information standard and amendments.

The Board requests comments on specific questions included in this Appendix as well as on its proposal in general. Additionally, the Board is seeking comment on economic considerations related to the proposed other information standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters. Commenters providing cost estimates are requested to provide the basis for any estimate provided. Finally, the Board is seeking comment on the applicability of the proposed other information standard and amendments to the audits of brokers and dealers. Considerations related to the applicability of the proposed other information standard and amendments to audits of emerging growth companies are discussed in Appendix 7.

The following sections describe the requirements in the proposed other information standard and amendments.

## **I. Introduction (Paragraph 1 of the Proposed Other Information Standard)**

The proposed other information standard establishes requirements regarding the auditor's responsibilities with respect to the other information in certain documents containing audited financial statements and the related auditor's report. As more fully described later in this section, the introduction to the proposed other information standard provides a description of "other information," as used in the proposed other

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<sup>5/</sup> SAG meeting transcripts for November 2011 and 2012 are available at [http://pcaobus.org/Rules/Rulemaking/Docket034/11102011\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf), [http://pcaobus.org/Rules/Rulemaking/Docket034/11162012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf), and [http://pcaobus.org/Rules/Rulemaking/Docket034/11152012\\_SAG\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf).

information standard, including (1) the documents to which the proposed other information standard would apply and (2) the information to which the proposed other information standard would not apply.

**A. Description of Other Information and Applicability of the Proposed Other Information Standard**

*1. Description of Other Information*

The proposed other information standard describes "other information" as information, other than the audited financial statements<sup>6/</sup> and the related auditor's report, in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") and contains that company's audited financial statements and the related auditor's report. The auditor's responsibilities with respect to other information outside the financial statements would thus focus on other information contained in annual reports filed with the SEC, such as Form 10-K. Annual reports filed with the SEC contain other information that is relevant and of interest to investors and other financial statement users.

Annual reports filed with the SEC under the Exchange Act may include information incorporated by reference from other SEC filings. Under the proposed other information standard, other information includes information contained in the annual report that is filed with the SEC under the Exchange Act as well as specific information that is incorporated by reference into the annual report.

Specifically, a note to the introduction of the proposed other information standard clarifies when information that is incorporated by reference would be included in the scope of the proposed other information standard. The note provides that other information includes information incorporated by reference into the Exchange Act annual report when the information is available to the auditor prior to the issuance of the auditor's report. Additionally, when the annual report is a Form 10-K, the other information in the annual report includes specific information incorporated by reference that is available to the auditor subsequent to the issuance of the auditor's report when that information is contained in the company's definitive proxy statement filed within 120

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<sup>6/</sup> This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b).

days after the end of the fiscal year covered by the Form 10-K. No other information incorporated by reference in the annual report that is not available to the auditor prior to the issuance of the auditor's report is included in the scope of the proposed other information standard.

Annual reports filed with the SEC under the Exchange Act may be amended from time to time, including when there are revisions to amounts or disclosures in the previously issued audited financial statements. Amended annual reports, such as the Form 10-K/A, that contain the company's audited financial statements and the related auditor's report, are included in the scope of the proposed other information standard.

When an amended annual report contains revisions to amounts or disclosures in the previously issued financial statements that affect the auditor's report that was filed with the initial Form 10-K, then the amended annual report would be treated similar to an initial filing on Form 10-K. In this situation, because the auditor essentially is considering whether to update or issue a new auditor's report,<sup>7/</sup> the auditor would perform all the procedures under the proposed other information standard.

When an amended annual report does not contain revisions to amounts or disclosures in the previously issued financial statements that affect the auditor's report that was filed with the initial Form 10-K, then the auditor would treat the other information in the amended filing as not available prior to the issuance of the auditor's report.<sup>8/</sup>

The scope of the proposed other information standard contains some similarities to, and some differences from, the Board's existing auditing standard relating to other information, AU sec. 550.

AU sec. 550 currently applies to other information contained in (1) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Exchange Act or (2) other documents to which the

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<sup>7/</sup> See AU sec. 530, *Dating of the Independent Auditor's Report*.

<sup>8/</sup> See Section IV.D., *Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report*.

auditor, at the client's request, devotes attention.<sup>9/</sup> Existing AU sec. 550 does not specifically mention information incorporated by reference into an annual report.

Thus, consistent with existing AU sec. 550, the proposed other information standard would apply to annual reports filed under the Exchange Act. However, certain other annual reports included in the scope of the existing standard, such as a company's annual report to security holders that is provided to, but not filed with, the SEC (sometimes referred to as the "glossy" annual report because it may appear as a glossy publication) would not be within the scope of the proposed other information standard. As discussed further below, in some cases, a glossy annual report may be incorporated by reference, either in whole or in part, into a company's Form 10-K prior to the issuance of the auditor's report. In those circumstances, the portions of the glossy annual report, other than the financial statements, that are incorporated by reference would be considered other information under the proposed other information standard.

Additionally, unlike existing AU sec. 550, the proposed other information standard would not apply to other documents to which the auditor, at the company's request, devotes attention. The proposed other information standard does not preclude the auditor from applying the procedures in the standard to such other documents. Also, the proposed other information standard does not preclude the auditor from applying additional procedures not described in the proposed other information standard to the other information.

Finally, the proposed other information standard is consistent with existing AU sec. 550 in that it would not apply to documents filed with the SEC under the Securities Act of 1933 ("Securities Act").<sup>10/</sup> The proposed other information standard, like AU sec. 550, refers the auditor to AU sec. 711, *Filings Under Federal Securities Statutes*, and the auditor's responsibilities for Securities Act filings under the federal securities laws.<sup>11/</sup> The Board recognizes, however, that certain Securities Act filings may incorporate by reference annual reports containing audited financial statements and audit reports that are filed with the SEC under the Exchange Act. For a further discussion regarding the Board's considerations related to Securities Act documents, see Section XII, *Considerations Related to Securities Act Documents*.

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<sup>9/</sup> See AU sec. 550.02.

<sup>10/</sup> See AU sec. 550.03.

<sup>11/</sup> See, e.g., Section 11(a) of the Securities Act, 15 U.S.C. § 77k(a).



2. *Applicability to Annual Reports Filed with the SEC under the Exchange Act That Contain Other Information*

As noted above, the proposed other information standard would apply to annual reports that are filed with the SEC under the Exchange Act that contain audited financial statements and the related auditor's report.

The proposed other information standard would apply to the version of the annual report document filed with the SEC either electronically using the Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system<sup>12/</sup> or as a paper filing.<sup>13/</sup> Because the proposed other information standard is limited to annual reports that are filed with the SEC, the auditor's responsibilities would not extend to annual reports that are distributed by other means, such as corporate websites or social media. Information on websites, such as a company's own website, might contain audited financial statements, the related auditor's reports, or data derived from SEC filings. Consistent with existing AU sec. 9550,<sup>14/</sup> the proposed other information standard would not require auditors to evaluate information contained in electronic sites.

The annual reports covered by the proposed other information standard would include annual reports filed on Forms 10-K, 20-F, 40-F, and N-CSR, among others. The other information contained in these annual report filings can vary depending on the requirements of the SEC form on which the filing is made. For example, other information in a company's annual report filed on Form 10-K would include, among other items, Risk Factors; Selected Financial Data; Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"); Certain Relationships and Related Transactions, and Director Independence; and exhibits.<sup>15/</sup>

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<sup>12/</sup> See SEC Rule 301 of Regulation S-T, 17 C.F.R. § 232.301. EDGAR currently provides an electronic filing process for submitting documents under the Securities Act, the Exchange Act, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

<sup>13/</sup> See SEC Rule 101 of Regulation S-T, 17 C.F.R. § 232.101. For example, employee stock purchase, savings and similar plans may choose to file their annual reports with the SEC in electronic or paper format.

<sup>14/</sup> See AU secs. 9550.16-.18.

<sup>15/</sup> Any documents contained in the list of exhibits to the annual report would be considered other information in an annual report under the proposed other

Other information filed by an investment company issuer on Form N-CSR would include, among other items, Code of Ethics and Management's Discussion of Fund Performance ("MDFP").<sup>16/</sup>

Additionally, under the proposed other information standard, management's assertion on internal control over financial reporting would be considered other information when that assertion is included in an annual report filed with the SEC that contains audited financial statements and the related auditor's report, and management's assertion is not subject to an auditor's attestation under Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The auditor's responsibilities under the proposed other information standard regarding management's assertion on internal control over financial reporting generally would be consistent with existing AU sec. 9550.<sup>17/</sup> AU sec. 9550 states that, because an auditor is required to consider internal control in an audit of the financial statements, the auditor may be familiar with matters covered in management's assertion on internal control over financial reporting.

3. *Applicability to Information Incorporated by Reference in Annual Reports Filed with the SEC under the Exchange Act*

In many cases, the information incorporated by reference into an annual report filed with the SEC is available to the auditor prior to the issuance of the auditor's report. For example, as discussed above, the entire or portions of a company's glossy annual report may be incorporated by reference<sup>18/</sup> into a company's Form 10-K.<sup>19/</sup> Under the

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information standard. The proposed other information standard would not apply to information formatted in eXtensible Business Reporting Language ("XBRL") that is furnished with the SEC as an exhibit or otherwise. See SEC, *Interactive Data to Improve Financial Reporting*, Release No. 33-9002 (Jan. 30, 2009) at 94-95 and 101.

<sup>16/</sup> See Item 27(b)(7) of SEC Form N-1A for open-end investment companies. Money market investment companies are exempt from this requirement to provide MDFP. Form N-2, which sets reporting requirements for closed-end funds, does not require MDFP.

<sup>17/</sup> See AU sec. 9550.07-.11.

<sup>18/</sup> See Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," paragraph (2). See also SEC Exchange Act Rule 12b-23, 17 C.F.R. § 240.12b-23.

<sup>19/</sup> Glossy annual reports may also be included as part of a combined report filed on Form 10-K. In this case, information from glossy annual reports, other than the

proposed other information standard, information incorporated by reference that is available to the auditor prior to the issuance of the auditor's report would be considered other information and covered by the proposed other information standard. The auditor's responsibilities for other information that is incorporated by reference and is available prior to the issuance of the auditor's report would be the same as the auditor's responsibilities for other information contained in the document filed with the SEC.

Under the proposed other information standard, with one exception, the auditor would not be responsible for information incorporated by reference that is not available to the auditor prior to the issuance of the auditor's report. Specifically, the proposed other information standard would apply to information incorporated by reference in a Form 10-K from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.<sup>20/</sup> Though this information may be filed subsequently, it is an essential part of the company's annual report on Form 10-K and is necessary to make the document complete.<sup>21/</sup>

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audited financial statements, would be considered other information under the proposed other information standard. See Form 10-K, 17 C.F.R. § 249.310, General Instructions H, "Integrated Reports to Security Holders."

<sup>20/</sup> The information required by Part III of Form 10-K (i.e., Item 10. Directors, Executive Officers and Corporate Governance; Item 11. Executive Compensation; Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters; Item 13. Certain Relationships and Related Transactions, and Director Independence; and Item 14. Principal Accountant Fees and Services) may be incorporated by reference from a proxy statement. See SEC Exchange Act Rule 12b-23, 17 C.F.R. § 240.12b-23. See also Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," Paragraph (3).

<sup>21/</sup> The standard also would apply to the other information that was to be incorporated by reference from the proxy statement but was instead filed as an amendment to the Form 10-K. If a proxy statement is not filed with the SEC within 120 days after the end of the fiscal year covered by the Form 10-K, the information that was to be incorporated by reference from the proxy statement is instead filed as an amendment to the Form 10-K. See Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," paragraph (3).

**B. Information Included in Annual Reports Containing Audited Financial Statements and the Related Auditor's Report to Which the Proposed Other Information Standard Would Not Apply**

Consistent with AU sec. 550,<sup>22/</sup> the proposed other information standard would not apply to (1) supplemental information addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*,<sup>23/</sup> and (2) required supplementary information addressed by AU sec. 558, *Required Supplementary Information*. The proposed other information standard also would not apply to management's assertion on internal control over financial reporting in an audit of internal control over financial reporting that is integrated with an audit of the financial statements.<sup>24/</sup> The information described in these circumstances would be subject to audit or other procedures under other PCAOB standards named above. Therefore, there is no need to impose the requirements of the proposed other information standard on that information because the auditor's responsibilities are already described in the other PCAOB standards.

The proposed other information standard would apply to the other information in the annual report of the company that is making the filing. Audited financial statements of an entity other than the company, such as a business acquired or to be acquired, may be required to be included in the company's annual report.<sup>25/</sup> The Board does not intend for the other entity's financial statements to be considered other information in the company's annual report, under the proposed other information standard, because they are not the company's financial statements and were already subject to a separate audit. Although the Board does not intend for the proposed other information standard to apply in such situations, the Board is seeking comment on whether the proposed other information standard should apply to audited financial statements of another entity that are required to be filed in a company's report under Article 3 of Regulation S-X and whether there are practical issues of doing so.

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<sup>22/</sup> See AU sec. 550.03.

<sup>23/</sup> See *Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements, and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-005 (July 12, 2011).

<sup>24/</sup> See Auditing Standard No. 5.

<sup>25/</sup> See Article 3 of Regulation S-X.

Questions Related to Section I:

1. Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?
2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?
3. Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?
4. Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?

**II. Objectives (Paragraph 2 of the Proposed Other Information Standard)**

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed other information standard to highlight the overall context for the requirements of the standard. Providing an overarching concept as audit objectives for the auditor to take into account can assist the auditor in performing the procedures required by the proposed other information standard and evaluating the results of those procedures.

The proposed other information standard states that the objectives of the auditor are:

- To evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ("material inconsistency");

(2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and

- When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the audit, the other information contains a material inconsistency, a material misstatement of fact, or both.

The Board's existing standard, AU sec. 550 does not specifically identify an objective for the auditor regarding other information.

Question Related to Section II:

5. Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?

**III. Evaluating the Other Information (Paragraphs 3 – 5 of the Proposed Other Information Standard)**

The proposed other information standard would require the auditor to evaluate whether the other information contains (1) a material inconsistency, (2) a material misstatement of fact, or (3) both. As more fully described later in this section, the auditor's evaluation would include reading the other information and performing specific procedures based on relevant audit evidence obtained and conclusions reached during the audit.

AU sec. 550 currently requires the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.<sup>26/</sup> Additionally, if, while reading the other information for a material inconsistency, the auditor becomes aware of information that the auditor believes is a material misstatement of fact, that is not a material inconsistency, the auditor is required to discuss the matter with management.<sup>27/</sup> Existing AU sec. 550 does not specify the procedures that the auditor should perform when considering the other information, but the standard describes the auditor's responsibilities for responding to identified material inconsistencies or material misstatements of fact.

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<sup>26/</sup> See AU sec. 550.04.

<sup>27/</sup> See AU sec. 550.05.



**A. Material Inconsistency (Paragraph 3 of the Proposed Other Information Standard)**

The proposed other information standard generally retains the description of material inconsistency under existing AU sec. 550. A material inconsistency would exist under the proposed other information standard when the other information is materially inconsistent with amounts or information, or the manner of their presentation, in the audited financial statements. The other information often includes amounts or qualitative statements that are directly related to the financial statements because they are intended to be the same as, or to provide greater detail about, amounts or information in the financial statements.

A material inconsistency would involve an inconsistency between amounts in the financial statements and amounts in the other information that have a direct relationship to the company's financial statements, such as quantitative information in the Selected Financial Data or MD&A sections, among others, of an annual report on Form 10-K, but would not be limited to only quantitative information. Qualitative statements, such as the description of the company's critical accounting policies, estimates, and related assumptions in the other information of an annual report on Form 10-K, also would be directly related to accounts and disclosures in the financial statements and thus might involve a material inconsistency.

**B. Material Misstatement of Fact (Paragraph 3 of the Proposed Other Information Standard)**

The proposed other information standard also retains the concept of material misstatement of fact in AU sec. 550. Similar to the existing standard, the proposed other information standard does not define material misstatements of fact, but describes the concept of material misstatements of fact in the context of the auditor's responsibilities.

Material misstatements of fact could relate to, among others, statements about the company's competitive environment, technological developments, or supplier relationships. Although such statements in the other information do not directly relate to the accounts and disclosures in the financial statements, the auditor might have knowledge of such information as part of obtaining audit evidence or reaching conclusions during the audit.<sup>28/</sup> Such statements also might be an important driver of the company's stock market value or be of particular importance to investors.

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<sup>28/</sup> For example, during the audit, the auditor may obtain such information as audit evidence in connection with obtaining an understanding of the company and its

For example, management might state in the other information that the company has the largest market share in the company's industry. This information could be material to an investor's decision about the company. The auditor might be aware, based on relevant audit evidence obtained during the audit, that the company does not have the largest share in the relevant industry. The proposed other information standard would require the auditor to evaluate whether management's statement represents a material misstatement of fact.

**C. Auditor's Responsibility to Evaluate (Paragraph 4 of the Proposed Other Information Standard)**

The proposed other information standard would require the auditor to read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the other information. In order to strengthen the auditor's performance responsibilities to provide a basis for the auditor to evaluate the other information, the proposed other information standard provides specific procedures the auditor would perform related to the other information. The procedures set forth in paragraph 4 of the proposed other information standard involve using information and evidence already obtained by the auditor rather than procedures to obtain additional evidence.

In evaluating whether the other information contains a material inconsistency, a material misstatement of fact, or both, the auditor would refer to the definition of materiality under the federal securities laws. In interpreting those laws, the United States Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."<sup>29/</sup> As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ."<sup>30/</sup>

Since the purpose of evaluating the other information is to assess whether the other information contains a material inconsistency, a material misstatement of fact, or

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environment. See paragraph 9 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>29/</sup> TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also, Basic, Inc. v. Levinson, 485 U.S. 224, 231 to 232 (1988).

<sup>30/</sup> TSC Industries, 426 U.S. at 450.

both, the Board believes that it is appropriate for the auditor to use the established definition of materiality under the federal securities laws applicable to corporate reporting for this evaluation. Auditors should be familiar with this definition because, among other things, it is used to evaluate whether uncorrected misstatements detected during the audit are material.<sup>31/</sup> The Board understands that MD&A and other parts of the other information may contain information that does not reach the quantitative materiality level established for purposes of planning the audit<sup>32/</sup> and that the auditor accordingly may not have obtained audit evidence concerning those matters. As discussed above, the auditor's responsibility to evaluate such information would be based on relevant audit evidence obtained and conclusions reached during the audit. If, however, on that basis, the auditor identifies a potential inconsistency or misstatement of fact in the other information, the auditor should assess its materiality under the federal securities laws' definition of that term.

1. *Auditor's Responsibility to Read*

As noted above, the proposed other information standard retains the requirement of existing AU sec. 550 for the auditor to read the other information. The requirement "to read" in the proposed other information standard has the same meaning as in AU sec. 550 and other PCAOB standards, such as reading interim financial information,<sup>33/</sup> board minutes,<sup>34/</sup> prospectuses and registration statements,<sup>35/</sup> and other information by the engagement quality reviewer or during a review of interim financial information.<sup>36/</sup>

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<sup>31/</sup> See paragraph 17 of Auditing Standard No. 14, *Evaluating Audit Results*.

<sup>32/</sup> See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

<sup>33/</sup> See, e.g., paragraphs .11 and .18.e. of AU sec. 722, *Interim Financial Information*.

<sup>34/</sup> See, e.g., AU secs. 722.18.a. and .19.

<sup>35/</sup> See, e.g., AU secs. 711.08-.11.

<sup>36/</sup> See, e.g., paragraphs 10.g. and 15.e. of Auditing Standard No. 7, *Engagement Quality Review*, and AU sec. 722.18.f.

## 2. Auditor's Responsibility to Evaluate

The proposed other information standard describes the auditor's responsibility as "should evaluate" the other information. Existing AU sec. 550 states that the auditor "should consider" whether the other information is materially inconsistent with the financial statements. AU sec. 550 further indicates that if the auditor concludes that there is a material inconsistency with the financial statements based on the auditor's reading and considering, then the auditor should perform certain procedures.<sup>37/</sup>

The proposed other information standard does not retain the term "should consider." PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, indicates that if a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory while the action or procedure is not. As used in AU sec. 550, "should consider" is not followed by a specific action or procedure, but rather is described as a stand-alone requirement without further context regarding the action or procedure. "Should evaluate" is used in other PCAOB standards when the auditor is expected to come to a conclusion based on the performance of certain procedures.<sup>38/</sup>

The proposed other information standard differs from AU sec. 550 in that it requires the auditor to evaluate the other information for both a material inconsistency and a material misstatement of fact. Under existing AU sec. 550, the auditor's responsibility for a material misstatement of fact is conditioned on the auditor "becoming aware" of a material misstatement of fact while reading the other information for a material inconsistency. AU sec. 550 also currently states that, if the auditor becomes aware of information that he or she believes is a material misstatement of fact, that is not a material inconsistency, the auditor should consider that he or she may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion.<sup>39/</sup>

The proposed other information standard would require the auditor to evaluate the other information for a material inconsistency and for a material misstatement of fact

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<sup>37/</sup> See AU sec. 550.04.

<sup>38/</sup> See, e.g., Auditing Standard No. 7 and Auditing Standard No. 12.

<sup>39/</sup> See AU sec. 550.05.

based on relevant audit evidence obtained and conclusions reached during the audit. A consistent requirement to evaluate the other information for both material inconsistencies and for material misstatements of fact is appropriate because the auditor's evaluation would be based on the same factors – relevant audit evidence obtained and conclusions reached during the audit.

3. *Performing Procedures to Evaluate the Other Information*

In addition to reading the other information, the auditor's evaluation under the proposed other information standard would include performing procedures intended to help the auditor identify whether the other information contains material inconsistencies and material misstatements of fact. Existing AU sec. 550 does not specify any procedures for the auditor to perform in considering the other information.

The required procedures in the proposed other information standard set forth the nature and extent of the auditor's work to evaluate the other information. The procedures in paragraph 4 of the proposed other information standard involve using information and evidence already obtained by the auditor rather than procedures to obtain additional evidence. Specifically, the auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. Under other PCAOB standards, the auditor is required to obtain sufficient appropriate audit evidence<sup>40/</sup> and reach conclusions during the audit.<sup>41/</sup> These existing responsibilities provide the basis for the auditor's evaluation of the other information under the proposed other information standard.

Some commenters on the concept release indicated that they are aware that some auditors perform certain procedures related to the other information, such as comparing numbers in the other information to the audited financial statements, recalculating percentages, and providing input to management regarding the other information. Similarly, the Commission on the Auditors' Responsibilities established by the American Institute of Certified Public Accountants (known as the "Cohen Commission"), which examined the auditor's responsibilities and the form of the auditor's report, recommended in 1978 – prior to the establishment of the PCAOB – that the auditing standard for other information be revised to require the auditor to (1)

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<sup>40/</sup> See Auditing Standard No. 15, *Audit Evidence*.

<sup>41/</sup> See Auditing Standard No. 14 and paragraphs 62-73 of Auditing Standard No. 5.

compare the other information to the financial statements and the audit work papers for inconsistencies with the auditor's knowledge as a result of the audit and (2) recompute percentages or information presented in a manner different from that in the financial statements.<sup>42/</sup> These recommendations of the Cohen Commission have never been adopted as requirements for the auditor.

Because existing AU sec. 550 does not require procedures other than to "read and consider" the other information, the application of the auditor's responsibilities regarding other information among accounting firms may not be consistent. While the Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard, the Board's proposal is designed to promote a consistent basis for the auditor's evaluation of other information. The required procedures are discussed in Subsections a.–d. of this Section.

The proposed procedures are more specific than the "read and consider" approach in existing AU sec. 550 and thus likely would increase auditor effort and, therefore, costs for firms, particularly those firms that might not currently be performing similar procedures on the other information. Also, enhancing the auditor's responsibilities from "becoming aware" of a material misstatement of fact under existing AU sec. 550<sup>43/</sup> to performing specific procedures to evaluate whether the other information contains a material misstatement of fact might result in additional auditor effort. It is also anticipated that auditors would incur one-time costs related to the proposed other information standard, such as updating firm audit methodologies to reflect the new performance and reporting requirements and training firm personnel.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's financial statements and on the identification of material misstatements of fact, based on relevant audit evidence obtained and conclusions reached during the audit. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors

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<sup>42/</sup> See AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 69 available at [http://www.sechistorical.org/collection/papers/1970/1978\\_0101\\_CohenAuditors.pdf](http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf).

<sup>43/</sup> See AU sec. 550.05.



and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,<sup>44/</sup> or intentional misreporting.<sup>45/</sup> As a result of the auditor's evaluation of other information, and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information<sup>46/</sup> available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors also could facilitate more efficient capital allocation decisions.<sup>47/</sup> Academic research has shown that the increased quality of information could result in a reduction in the average cost of capital.<sup>48/</sup>

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<sup>44/</sup> See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 *Journal of Accounting and Economics* 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting*, Unpublished working paper (2013) available at <http://ssrn.com/abstract=929731>.

<sup>45/</sup> See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 *Journal of Accounting Research* 1135, 1135-1166 (2009).

<sup>46/</sup> The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 *Journal of Accounting Research* 1, 1-42 (1982).

<sup>47/</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1-29 (2011).

<sup>48/</sup> Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, see Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of*

a. Amounts in the Other Information Related to the Financial Statements  
(Paragraph 4.a. of the Proposed Other Information Standard)

For amounts in the other information that are intended to be the same as, or provide greater detail about, amounts in the financial statements, the auditor would be required to evaluate the consistency of the amounts and the manner of their presentation with the financial statements or relevant evidence obtained during the audit. If the amounts in the other information are at the same level of detail as those in the financial statements, for example, amounts in the Selected Financial Data section, among others, of an annual report on Form 10-K, the auditor would evaluate the consistency of the amounts with amounts in the financial statements.

The other information also might contain amounts that are more disaggregated than the amounts in the financial statements. For example, amounts related to Results of Operations in the MD&A section, among others, of Form 10-K might be presented in a way that provides greater detail on a geographic or product basis than the amounts presented in the financial statements. In those situations, the auditor would evaluate the consistency of the amounts in the other information and the manner of their presentation with relevant evidence obtained during the audit that includes disaggregated information.

b. Qualitative Statements in the Other Information Related to the Financial  
Statements (Paragraph 4.b. of the Proposed Other Information Standard)

For any qualitative statement in the other information that is intended to represent, or provide greater detail about, information in the financial statements, the auditor would evaluate the consistency of the information and the manner of its presentation with the financial statements, including the financial statement disclosures, and with relevant audit evidence. Such qualitative other information might appear in the MD&A section, among others, of Form 10-K and relate to, for example, critical accounting policies, practices, and estimates or the description of off-balance sheet arrangements.

c. Other Information That Is Not Directly Related to the Financial Statements  
(Paragraph 4.c. of the Proposed Other Information Standard)

With respect to other information that is not directly related to the financial statements, the auditor would compare the information to relevant audit evidence obtained and conclusions reached during the audit. Other information that is not directly related to the financial statements might appear in the Business, Risk Factors, or Quantitative and Qualitative Disclosures about Market Risk sections, among others, of an annual report on Form 10-K<sup>49/</sup> or the MDFP section of an annual report on Form N-CSR.<sup>50/</sup>

d. Recalculation of Amounts in the Other Information (Paragraph 4.d. of the Proposed Other Information Standard)

The proposed other information standard also would require the auditor to evaluate certain amounts in the other information by recalculating the amounts for mathematical accuracy. The amounts that would be subject to this procedure would be amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence.

For example, this requirement of the proposed other information standard would apply to amounts in the other information that the auditor can recalculate without the need to refer to a formula or when the formula is generally understood. The above-mentioned requirement would include amounts, such as totals or percentages, which are ordinarily calculated using simple mathematical operations that do not require a formula, as well as generally understood ratios, such as the current ratio. If the auditor needs to refer to a formula for the recalculation of an amount, such as for return on capital employed, the auditor would be required to recalculate the amount only when the formula is provided or described in the annual report. However, the auditor would not be required to evaluate the appropriateness or sufficiency of the formula used in the calculation.

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<sup>49/</sup> See Instructions to Form 10-K available at <http://www.sec.gov/about/forms/form10-k.pdf>.

<sup>50/</sup> See Item 27(b)(7) of SEC Form N-1A for open-end investment companies. Money market investment companies are exempt from this requirement to provide MDFP.

**D. Responding When the Auditor Identifies a Potential Material Inconsistency, A Potential Material Misstatement of Fact, or Both (Paragraph 5 of the Proposed Other Information Standard)**

As a result of performing the evaluation procedures under paragraph 4 of the proposed other information standard, the auditor might identify a potential material inconsistency, a potential material misstatement of fact, or both. If so, the proposed other information standard would require the auditor to discuss the matter with the company's management. The proposed other information standard also would require that the auditor perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both. Such additional procedures might include (1) requests for additional documentation and (2) consultations outside of the engagement team, such as a national office or other parties with appropriate expertise. The procedures would vary based on the auditor's evaluation of the relevant facts and circumstances.

It is anticipated that, in many situations, the auditor's discussion with management and the results of the additional procedures would provide the auditor with additional information that could be sufficient to enable the auditor to determine if there is a material inconsistency, a material misstatement of fact, or both. If the auditor determines that there is a material inconsistency between the other information and the audited financial statements, the auditor also would determine whether the financial statements or the other information would require revision. A material misstatement of fact generally would require revision of the other information, not the financial statements, because a material misstatement of fact in the other information is not directly related to the financial statements.

Existing AU sec. 550 does not specify the procedures to be performed when the auditor identifies a potential material inconsistency but has not reached a conclusion about the material inconsistency. AU sec. 550 describes the auditor's responsibilities once the auditor has reached a conclusion that a material inconsistency exists. However, when the auditor becomes aware of information that the auditor believes is a material misstatement of fact, and prior to reaching a conclusion about the material misstatement of fact, AU sec. 550 currently requires the auditor to discuss the matter with management.<sup>51/</sup> The requirement in the proposed other information standard to discuss the matter with management is similar to the requirement in AU sec. 550 regarding a material misstatement of fact.

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<sup>51/</sup> See AU sec. 550.05.

If the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, and the auditor performs additional procedures, as necessary, the additional procedures likely would result in additional auditor effort as compared to the existing requirements in AU sec. 550.

Questions Related to Section III:

6. Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?
7. Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?
8. Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?
9. Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?
10. Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?
11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?
12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?
13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?

**IV. Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both (Paragraphs 6-11 of the Proposed Other Information Standard)**

**A. Communication with Management (Paragraph 6 of the Proposed Other Information Standard)**

If the auditor determines that the other information contains a material inconsistency, a material misstatement of fact, or both, the proposed other information standard would require the auditor to request management to revise the other information. This requirement was retained from AU sec. 550 with respect to a material inconsistency.<sup>52/</sup> However, with respect to a material misstatement of fact, AU sec. 550 does not include an explicit requirement for the auditor to request that management revise the other information. Rather, AU sec. 550 includes a requirement for the auditor to propose that management consult with other parties, such as legal counsel.<sup>53/</sup>

**B. The Auditor's Response If Management Does Not Appropriately Revise the Other Information (Paragraph 7 of the Proposed Other Information Standard)**

If management does not appropriately revise the other information, the auditor's response under the proposed other information standard would vary depending on whether the other information had been available to the auditor prior to the issuance of the auditor's report. When the other information is available to the auditor prior to the issuance of the auditor's report and management, in response to a request by the auditor, does not revise appropriately the other information to address a material inconsistency, a material misstatement of fact, or both, then the auditor would be required to perform certain procedures that are described in paragraphs 8 and 9 of the proposed other information standard and in Section IV.C., *Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report*, below. Additionally, when the other information is not available to the auditor prior to the issuance of the auditor's report and the other information is not appropriately revised by management, then the auditor would be required to perform other procedures described in paragraphs 10 and 11 of the proposed other information standard and in Section

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<sup>52/</sup> See AU sec. 550.04.

<sup>53/</sup> See AU sec. 550.05.



IV.D., *Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report* below.

**C. Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report (Paragraphs 8-9 of the Proposed Other Information Standard)**

Paragraphs 8-9 of the proposed other information standard set forth the auditor's response when (1) the auditor has determined that the other information available to the auditor prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both and (2) the information is not appropriately revised by management. When the other information is available prior to the issuance of the auditor's report, the auditor's response would be the same whether the information is contained in the annual report or is incorporated by reference in it.

1. *Communication with the Audit Committee (Paragraph 8 of the Proposed Other Information Standard)*

If management does not appropriately revise the other information after the auditor's request, the proposed other information standard would require the auditor to communicate the material inconsistency, the material misstatement of fact, or both, to the audit committee in a timely manner and prior to the issuance of the auditor's report.

Under existing AU sec. 550, if the other information is not revised to eliminate the material inconsistency, the auditor is required to communicate the material inconsistency to the audit committee.<sup>54/</sup> Additionally, if the auditor has concluded that a material misstatement of fact remains after communication to management, AU sec. 550 states that the auditor should communicate the material misstatement of fact to the audit committee, in writing.<sup>55/</sup>

The proposed other information standard would retain the requirements for the auditor to communicate to the audit committee, but would not require the communications regarding a material misstatement of fact to be in writing. This is consistent with the approach taken to communications to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees*, which allows the

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<sup>54/</sup> See AU sec. 550.04.

<sup>55/</sup> See AU sec. 550.06.

communication to be oral or written.<sup>56/</sup> Auditing Standard No. 16, however, requires the auditor to document communications with the audit committee in the work papers, whether such communications took place orally or in writing.<sup>57/</sup>

2. *Responding When the Other Information Is Not Appropriately Revised (Paragraph 9 of the Proposed Other Information Standard)*

If the other information is not appropriately revised after the auditor's communication with the audit committee, the proposed other information standard would require the auditor to determine his or her responsibilities under Section 10A of the Exchange Act ("Section 10A"),<sup>58/</sup> AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and AU sec. 317, *Illegal Acts by Clients*. This would direct the auditor to his or her responsibilities under federal securities laws and other PCAOB standards.

Section 10A includes requirements that apply when the auditor detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred.<sup>59/</sup> AU sec. 316 provides requirements regarding the auditor's responsibilities related to fraud in the audit of financial statements. AU sec. 317 provides the nature and extent of the auditor's consideration in the audit of financial statements of the possibility for an illegal act by the company.

Additionally, if the other information is not appropriately revised after the auditor's communication to the audit committee, the proposed other information standard would require the auditor to determine whether to (1) issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both or (2) withdraw from the engagement. In determining whether to issue an auditor's report when the other information is not appropriately revised after the auditor's communication to the audit committee, the auditor would consider, among other things, the implications of being associated with an annual report that contains a material inconsistency, a material

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<sup>56/</sup> See paragraph 25 of Auditing Standard No. 16.

<sup>57/</sup> Id.

<sup>58/</sup> 15 U.S.C. § 78j-1.

<sup>59/</sup> See Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b).

misstatement of fact, or both. The Board is seeking comments regarding the appropriateness of issuing an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both.

The proposed other information standard requires the same response and reporting by the auditor for both a material inconsistency and a material misstatement of fact in the other information because the auditor's evaluation of other information would be based on the same factors – relevant audit evidence obtained and conclusions reached during the audit. Investors are likely to be interested in matters that the auditor determined are material inconsistencies or material misstatements of fact in the other information. Additionally, investors might consider the other information that is directly related to the financial statements, as well as the other information that is not directly related to the financial statements, important in their investment decision making.<sup>60/</sup> Therefore, the proposed other information standard aligns the reporting responsibilities for both a material inconsistency and a material misstatement of fact.

There may be circumstances in which the auditor determines that issuing an auditor's report is not appropriate. Similar to existing AU sec. 550,<sup>61/</sup> such circumstances may arise when the nature of the material inconsistency or material misstatement of fact is such that it may affect the auditor's decision to be associated with the annual report. Under the proposed other information standard, such circumstances would require the auditor to determine whether to withdraw from the

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<sup>60/</sup> See, e.g., IAG survey, *Role, Relevancy, and Value of the Audit*. The responses to survey question 13 indicate that investors often use other information, such as (1) MD&A, (2) Business Description, (3) Risk Factors, and (4) Proxy Information, to make investment decisions. The survey results were presented at the March 2012 IAG meeting and are available at [http://pcaobus.org/News/Events/Documents/03282012\\_IAGMeeting/Audit\\_Firm\\_Practice\\_Survey\\_Summary.pdf](http://pcaobus.org/News/Events/Documents/03282012_IAGMeeting/Audit_Firm_Practice_Survey_Summary.pdf).

<sup>61/</sup> See AU sec. 550.04, which states, in part, that "[o]ther information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report." It further states that if the other information is not revised to eliminate the material inconsistency "[t]he action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information."

engagement. Consideration of similar actions is currently required by AU sec. 550 with respect to material inconsistency,<sup>62/</sup> but that standard does not specify the auditor's responses with respect to a material misstatement of fact.

The proposed other information standard notes that the auditor may withhold the use of the auditor's report for a prior reporting period. If the auditor determines that it is not appropriate to issue an auditor's report for the current reporting period, the auditor also may withhold the use of the auditor's report for a prior reporting period. This is similar to existing AU sec. 550, which states that the auditor should consider actions such as withholding the use of the auditor's report in the annual report, if the other information is not revised to eliminate the material inconsistency.<sup>63/</sup> AU sec. 550, however, does not specify the period for which the report may be withheld.

**D. Responding When the Other Information is Not Available Prior to the Issuance of the Auditor's Report (Paragraphs 10-11 of the Proposed Other Information Standard)**

Paragraphs 10-11 of the proposed other information standard set forth the auditor's response when (1) the auditor has determined that certain other information, that is not available to the auditor prior to the issuance of the auditor's report, contains a material inconsistency, a material misstatement of fact, or both and (2) the information has not been appropriately revised by management.<sup>64/</sup>

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<sup>62/</sup> See AU sec. 550.04.

<sup>63/</sup> Id.

<sup>64/</sup> With respect to other information in an amended annual report that contains previously issued audited financial statements and the related auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of the proposed other information standard. Those paragraphs also would apply to (1) information incorporated by reference in a Form 10-K from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K and (2) other information that was to be incorporated by reference from the company's definitive proxy statement but was instead filed as an amendment to the Form 10-K.

1. *Communication with the Audit Committee (Paragraph 10 of the Proposed Other Information Standard)*

If, after the auditor's request, management does not appropriately revise the other information that was not available prior to the issuance of the auditor's report, the proposed other information standard would require the auditor to communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner. This requirement is similar to the requirement when the other information is available prior to the issuance of the auditor's report.

2. *Responding When the Other Information Is Not Appropriately Revised (Paragraph 11 of the Proposed Other Information Standard)*

If the other information is not appropriately revised after the auditor's communication of the material inconsistency, material misstatement of fact, or both to the audit committee, and the auditor's report has been issued, the proposed other information standard would require the auditor to determine his or her responsibilities under Section 10A.<sup>65/</sup> Section 10A includes requirements that apply when the auditor detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred.<sup>66/</sup>

Additionally, the proposed other information standard would require the auditor to apply the procedures in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. AU sec. 561 provides procedures for the auditor when, subsequent to the date of the auditor's report, the auditor becomes aware that facts may have existed at that date which might have affected the auditor's report if the auditor had been aware of them.<sup>67/</sup>

The procedures in AU sec. 561 would apply in a situation in which the other information that was not available prior to the issuance of the auditor's report was not revised to eliminate a material inconsistency, a material misstatement of fact, or both.<sup>68/</sup>

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<sup>65/</sup> 15 U.S.C. § 78j-1.

<sup>66/</sup> See Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b).

<sup>67/</sup> See AU sec. 561.01.

<sup>68/</sup> See AU secs. 561.05 and .08-09.a.

For example, if the auditor identified a material inconsistency, a material misstatement of fact, or both in the related party information in a proxy statement covered by this standard, the auditor would:

- Determine the effect on the auditor's report if (1) the material inconsistency between the information about related parties in the other information and the audited financial statements, (2) the material misstatement of fact in the other information about related parties, (3) or both had been known to the auditor prior to the issuance of the auditor's report;<sup>69/</sup> and
- Notify each member of the company's board of directors of the material inconsistency, material misstatement of fact, or both, in the related party information and that if the other information is not appropriately revised, the auditor would take steps to prevent future reliance on the auditor's report.<sup>70/</sup>

If the other information is not appropriately revised after the auditor's notification to the board of directors, in this example the auditor would:

- Notify management and the audit committee that the auditor's report must no longer be associated with the financial statements;<sup>71/</sup> and
- Notify the SEC that the auditor's report should no longer be relied upon.<sup>72/</sup> This notification also would describe the effect the material inconsistency, material misstatement of fact, or both in the related party information would have had on "The Auditor's Responsibility Regarding Other Information" section in the auditor's report if it had been known to the

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<sup>69/</sup> See AU sec. 561.05.

<sup>70/</sup> See AU sec. 561.08. See also the auditor's communication requirements in Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and AU sec. 317.

<sup>71/</sup> See AU sec. 561.08a.

<sup>72/</sup> See AU sec. 561.08b. See also the auditor's communication requirements in Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and AU sec. 317.



auditor prior to the issuance of the auditor's report and describe the material inconsistency, material misstatement of fact, or both.<sup>73/</sup>

The auditor's responsibilities under AU sec. 561 are not affected when the auditor has resigned or been discharged.<sup>74/</sup> The auditor's responsibilities under the proposed other information standard to apply the procedures in AU sec. 561 similarly would not be affected by the auditor's resignation or dismissal.

Questions Related to Section IV:

14. Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?
15. Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?
16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?

**V. Responding When the Auditor Determines That There Is a Potential Misstatement in the Audited Financial Statements (Paragraph 12 of the Proposed Other Information Standard)**

The procedures in the proposed other information standard would require the auditor to evaluate the consistency of the other information to the audited financial

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<sup>73/</sup> See AU sec. 561.09a.

<sup>74/</sup> See AU sec. 9561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of Section 561*.

statements. These procedures would provide an increased auditor focus on other information, which could improve the auditor's identification of potential misstatements in the financial statements. Academic research indicates that comparing non-financial measures commonly found in the other information, such as number of properties and employee headcount, among others, to audited financial statements can help the auditor identify red flags for fraudulent financial reporting.<sup>75/</sup> To the extent that discrepancies between non-financial measures and reported financial performance are red flags for possible financial reporting issues, including fraud, requiring auditors to evaluate other information could help them detect misstatements.

As a result of procedures performed under paragraphs 4 and 5 of the proposed other information standard, the auditor might determine that there is a potential misstatement in the audited financial statements. If the auditor's report on the financial statements has not been issued, the auditor would refer to the requirements of Auditing Standard No. 14 and amended AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, in this situation.

Auditing Standard No. 14 establishes requirements regarding the auditor's evaluation of audit results and the determination of whether the auditor has obtained sufficient appropriate audit evidence. The auditor's evaluation includes, among other things, an evaluation of misstatements accumulated during the audit.<sup>76/</sup> Proposed amendments to AU sec. 508, as reflected in Appendix 3, would describe the reporting requirements related to departures from an unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion.

If the auditor's report has already been issued, the proposed other information standard refers the auditor to the procedures in AU sec. 561. AU sec. 561 provides procedures for the auditor when, subsequent to the date of the auditor's report, the auditor becomes aware that facts may have existed at that date that might have affected the auditor's report if the auditor had been aware of them.<sup>77/</sup> Under AU sec. 561, the auditor is required to perform procedures to determine whether the information

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<sup>75/</sup> See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 *Journal of Accounting Research* 1135, 1135-1166 (2009).

<sup>76/</sup> See paragraph 4 of Auditing Standard No. 14.

<sup>77/</sup> See AU sec. 561.01.

is reliable and whether the facts existed at the date of the auditor's report, including discussing the matter with company management and the board of directors.<sup>78/</sup> The auditor's further responsibilities under AU sec. 561 depend on several factors, including, among others, the effect on the audited financial statements and the auditor's report.<sup>79/</sup>

Question Related to Section V:

17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?

**VI. Reporting in the Auditor's Report (Paragraphs 13-14 of the Proposed Other Information Standard)**

The proposed other information standard provides a basis for the auditor to report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. Reporting on the results of the auditor's evaluation of the other information would provide potentially significant information to investors.

The proposed other information standard would require that, when issuing an auditor's report, the auditor include specific statements regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of other information. The auditor would be required to make these statements in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information."<sup>80/</sup>

Regardless of whether the auditor identifies a material inconsistency, a material misstatement of fact, or both, when issuing an auditor's report, the auditor would be required to provide in the report the following:

- A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)],

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<sup>78/</sup> See AU sec. 561.05.

<sup>79/</sup> See AU secs. 561.05-.08.

<sup>80/</sup> The proposed auditor reporting standard refers the auditor to the reporting requirements of the proposed other information standard related to the auditor's responsibilities for and results of the auditor's evaluation of the other information.

in accordance with the standards of the PCAOB, the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

- Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and period end date of the financial statements;
- A statement that the auditor's evaluation was based on relevant audit evidence obtained and conclusions reached during the audit of the financial statements; and
- A statement that the auditor did not audit the other information and does not express an opinion on it.

In addition, depending on whether the auditor has identified a material inconsistency, a material misstatement of fact, or both, when issuing an auditor's report, the auditor would be required to provide a statement that:

- The auditor has not identified a material inconsistency or a material misstatement of fact in the other information; or
- The auditor has identified a material inconsistency, a material misstatement of fact, or both, in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

A statement in the auditor's report that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information is appropriate in situations in which (1) the auditor has not identified a material inconsistency or a material misstatement of fact based on the auditor's evaluation of the other information and (2) the auditor has identified a material inconsistency, a material misstatement of fact, or both, that the auditor requested management to revise and management appropriately revised prior to the issuance of the auditor's report. In situations when management has revised the other information at the auditor's request because the auditor identified material inconsistencies or material misstatements of fact, and the auditor determines that appropriate revisions have been made, then the auditor's report would state that the auditor has not identified a material inconsistency or a material

misstatement of fact in the other information since the annual report that is ultimately filed with the SEC no longer contains such inconsistencies or misstatements.<sup>81/</sup>

The proposed other information standard also provides illustrative language for the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The reporting requirements under the proposed other information standard are generally new. Existing AU sec. 508 does not require any statement in the auditor's report regarding the auditor's responsibilities with respect to other information. However, the proposed reporting responsibility when the auditor identified a material inconsistency that was not appropriately revised is similar to existing AU sec. 550 regarding a material inconsistency.<sup>82/</sup> Under AU sec. 550, if the other information is not revised to eliminate a material inconsistency, then the auditor is required to consider actions such as revising the report to include an explanatory paragraph describing the material inconsistency.

AU sec. 550 does not include a reporting responsibility regarding explanatory language for a material misstatement of fact in the other information. However, as noted above, the auditor's evaluation of the other information that is not directly related to the financial statements also might be important to investors in their investment decision making. Therefore, the proposed other information standard proposes the same reporting responsibilities for both a material inconsistency and a material misstatement of fact.

Some commenters supported including in the auditor's report a description of the auditor's responsibilities for other information. They generally indicated that such a description in the auditor's report would help users understand the auditor's responsibilities with respect to other information and address the misperception that the other information is audited. Additionally, some commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's

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<sup>81/</sup> In a situation in which the auditor identified a material inconsistency, a material misstatement of fact, or both that management subsequently revised, the auditor also has other responsibilities under other PCAOB standards, such as paragraphs 20-22 of Auditing Standard No. 14.

<sup>82/</sup> See AU sec. 550.04. See also existing AU sec. 508.11.h.

conclusions on the work performed in addition to the description of the auditor's responsibilities regarding other information.

The report of the Cohen Commission states that "[t]he lack of explicit acknowledgement of the auditor's responsibility for other information in the annual report has the potential to create user confusion . . ." <sup>83/</sup> Similar to the Board's proposal, the Cohen Commission recommended auditor reporting that includes a description of the auditor's work performed over the other information and the auditor's conclusions. <sup>84/</sup>

The Board notes that some of the other information not directly related to the audited financial statements might be non-financial in nature or related to the company's operations and, as a result, the auditor might not have obtained evidence or reached any conclusion regarding such information during the audit. The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.

Requiring the auditor to state that he or she has identified a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised would result in additional costs for the auditor related to situations in which a material inconsistency or a material misstatement of fact is identified, including the cost of conducting procedures to resolve and to report on such matters. Also, costs likely would arise for the company and its audit committee as a result of additional discussions with the auditor and others in connection with the description in the auditor's report.

Costs related to reporting under the proposed other information standard regarding a material inconsistency should be similar to those incurred under the existing AU sec. 550 because the requirements of the two standards are similar in this respect. Currently, the Board is not aware of any specific instance of an auditor's report being issued under the existing auditing standards <sup>85/</sup> and filed with the SEC that contains

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<sup>83/</sup> AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 69 available at [http://www.sechistorical.org/collection/papers/1970/1978\\_0101\\_CohenAuditors.pdf](http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf).

<sup>84/</sup> *Id.*

<sup>85/</sup> See AU sec. 550.04. See also existing AU sec. 508.11.h.



explanatory language regarding a material inconsistency.<sup>86/</sup> This suggests that instances of material inconsistency generally are resolved between the auditor and the company. Therefore, the related reporting costs might be low.

Questions Related to Section VI:

18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?
19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.
20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?
21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?
22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?

**VII. Responsibilities of a Predecessor Auditor**

Under existing auditing standards, before reissuing an auditor's report on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent

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<sup>86/</sup> In the audit reports of approximately 7,000 issuers with fiscal year 2011 filings, PCAOB staff did not identify any audit report containing explanatory language regarding a material inconsistency in the other information. PCAOB staff performed additional searches of SEC filings for other fiscal years and did not identify any audit report containing explanatory language regarding a material inconsistency in the other information.

period, a predecessor auditor should consider whether the auditor's report is still appropriate.<sup>87/</sup> Prior to reissuing the auditor's report the predecessor auditor is required to (1) read the current period financial statements; (2) compare the current period financial statements to the prior period financial statements being presented; and (3) obtain representation letters from management and the successor auditor.<sup>88/</sup>

In connection with the reissuance of a predecessor auditor's report, the proposed other information standard notes that the requirements of the standard related to a material inconsistency would apply to a predecessor auditor in situations in which the predecessor auditor's report is included in an Exchange Act annual report containing other information filed with the SEC.<sup>89/</sup> The proposed other information standard would apply to a predecessor auditor only with respect to a material inconsistency between the other information and the financial statements for the period audited by the predecessor auditor. The requirements in the proposed other information standard with respect to a predecessor auditor are similar to those of AU sec. 550.<sup>90/</sup>

As described in existing AU sec. 508.73, a predecessor auditor's knowledge of the current activities of the company would be limited in the absence of a continuing relationship. Additionally, the procedures required of the predecessor auditor prior to reissuing the auditor's report<sup>91/</sup> do not provide the predecessor auditor with additional audit evidence or new conclusions related to the previous audit. Therefore, the predecessor auditor would not be able to evaluate other information not directly related to the prior period financial statements that is contained in the current period Exchange Act annual report filed with the SEC. For this reason, the proposed other information standard, consistent with existing AU sec. 550,<sup>92/</sup> does not include a responsibility for the predecessor auditor with respect to a material misstatement of fact.

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<sup>87/</sup> See AU sec. 508.71.

<sup>88/</sup> Id.

<sup>89/</sup> See footnote 6 of the proposed other information standard.

<sup>90/</sup> See footnote 2 of AU sec. 550.

<sup>91/</sup> See existing AU sec. 508.71.

<sup>92/</sup> See footnote 2 of AU sec. 550.

The proposed other information standard would require the predecessor auditor to perform the procedures with respect to a material inconsistency based on relevant audit evidence obtained and conclusions reached during the predecessor auditor's previous audit. Therefore, the predecessor auditor's procedures would include reading and evaluating the other information in the current period annual report filed with the SEC for any material inconsistencies with the audited financial statements for the prior period. The predecessor auditor's procedures are not intended as an evaluation, with the benefit of hindsight, of the accuracy of the estimates and assumptions used in preparing the prior period's financial statements.

If the predecessor auditor concludes that there are no material inconsistencies, the predecessor auditor's report may be reissued. If, after communication with management and the audit committee, the predecessor auditor determines that the other information contains a material inconsistency, the predecessor auditor would be required to determine his or her responsibilities under federal securities laws and PCAOB standards. The predecessor auditor also may withhold the use of the auditor's report for the prior period.

Question Related to Section VII:

23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?

**VIII. Other Considerations**

Liability may be imposed on auditors and issuers (as well as 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,<sup>93/</sup> Section 10(b) of the Exchange Act, as well as various state law causes of action. The Board is interested in the effect of such liability considerations and, accordingly, requests comments on the potential legal liabilities associated with the performance and reporting requirements under the proposed other information standard.

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<sup>93/</sup> For example, the proposed reporting of the results of the auditor's evaluation of the other information may raise for auditors possible liability considerations under Section 11 of the Securities Act when the document filed under the Exchange Act that contains the proposed enhanced auditor's report is incorporated by reference into a registration statement filed under the Securities Act.

The Board's proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information; (2) including specific procedures for the auditor to perform with respect to evaluating the other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report. The following discussion is intended to highlight some key Board considerations in developing each element.

The first element of the Board's proposal would require the auditor to describe, in the auditor's report, the auditor's responsibilities for other information in annual reports containing audited financial statements and the related auditor's report filed with the SEC under the Exchange Act. Many commenters suggested that including a description in the auditor's report would provide useful information to investors.

The second element of the Board's proposal involves specific procedures, based on relevant audit evidence and the auditor's conclusions, for (1) assessing the consistency of the other information with the amounts, information, and presentation of the financial statements and (2) identifying material misstatements of fact. Under the proposed other information standard, the auditor would evaluate the other information for consistency with the financial statements and for potential misstatements of fact because the auditor is knowledgeable about the company's financial statements and the audit evidence obtained during the audit.

In developing this aspect of its proposed approach, the Board took note of relevant comments on the concept release. Some commenters noted that auditors have responsibilities under existing PCAOB standards to read and consider information outside of the financial statements and that auditors have developed procedures and routinely review other information for consistency with the financial statements. Other commenters suggested that performing procedures over information prepared by the company is a traditional role for the auditor that maintains the appropriate line of accountability between the auditor and the company. The Board's proposal (1) incrementally strengthens the auditor's traditional role with respect to other information and (2) provides a specific basis for describing the auditor's responsibilities in the auditor's report.

Third, the Board is proposing specific responses and reporting based on the results of the auditor's evaluation. For example, when the auditor has not identified a material inconsistency or material misstatement of fact as a result of the evaluation of the other information, the auditor's report would describe the auditor's responsibilities and note that no material inconsistencies or material misstatements of fact were

identified. However, when the auditor has identified a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised by management, the auditor would be required to describe the material inconsistency, material misstatement of fact, or both in the auditor's report, if the auditor determined it was appropriate to issue the auditor's report. The proposed other information standard also would refer the auditor to existing PCAOB standards, such as AU secs. 316 and 317, and to federal securities law requirements that are already familiar to auditors. The proposed other information standard also includes other responses for the auditor.

While the Board did not specifically seek comment in the concept release related to reporting on other information in the auditor's report, the Board received some related comments during its outreach and considered them in developing the proposed other information standard. In connection with adding the description of the auditor's responsibilities in the auditor's report, some commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed, in addition to the description of the auditor's responsibilities regarding other information. A commenter on the auditor assurance alternative presented in the concept release noted that auditors today would not permit their audit opinion to be included in a filing if the other information was inappropriate or incomplete.

The Board received other comments suggesting that reporting relating to the auditor's involvement with other information should be in a separate section of the auditor's report and include an introduction that described the different nature of the auditor's work and that the auditor was not auditing the other information. Accordingly, the Board is proposing that the auditor's statements regarding other information be in a separate section of the auditor's report, and also is proposing language to make it clear that the auditor is not expressing an opinion on the other information.

The Board recognizes, however, that, under its proposal, the auditor would be making new statements in the auditor's report about the auditor's responsibilities for evaluating other information and the results of the evaluation of the other information, which could raise potential liability considerations.

Questions Related to Section VIII:

24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the

other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?

25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?

## **IX. Proposed Amendments to PCAOB Standards**

The Board is proposing amendments to several of its existing auditing standards to conform to the proposed other information standard. Appendix 4 provides the proposed amendments related to the proposed other information standard. Significant amendments are described below.

### **A. Amendments to Existing AU sec. 508**

In situations in which the company has determined that it is not required to obtain, nor did the company request the auditor to perform, an audit of internal control over financial reporting, AU sec. 9550 states that the auditor may consider adding statements to the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's assertion.<sup>94/</sup> Because AU sec. 9550 would be superseded by the proposed other information standard, existing AU sec. 508 would be amended to allow the auditor to continue including such statements in the auditor's report.<sup>95/</sup> Existing AU sec. 508 also would be expanded to include an example of the "Basis of Opinion" section in the auditor's report that contains such statements.

In order to make this information consistently available to investors, the Board is interested in commenters' views about requiring, rather than allowing, statements in the auditor's report that the auditor was not engaged to examine management's assertion

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<sup>94/</sup> See AU sec. 9550.10.

<sup>95/</sup> See proposed paragraphs .74A-B of AU sec. 508 in Appendix 4.



on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report.<sup>96/</sup>

**B. Amendments to AU sec. 558**

AU sec. 558 includes a reference to AU sec. 550, which permits the auditor to express an opinion on certain other information if that information has been subjected to auditing procedures. If the auditor decides to report on such information, AU sec. 558 references the reporting requirements of AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

Since the proposed other information standard would supersede AU sec. 550 and the Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*,<sup>97/</sup> would supersede AU sec. 551, the Board is proposing to add the relevant substantive requirements, which otherwise would be superseded, directly to AU sec. 558. Accordingly, the Board is proposing to amend paragraph .09 of AU sec. 558 to include the elements of paragraph .07 of AU sec. 550 and paragraphs .12 and .14 of AU sec. 551 related to expressing an opinion on other information that has been subjected to auditing procedures. Because AU sec. 550 would be superseded, the proposed amendment to AU sec. 558 would apply only to situations involving required supplementary information.

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<sup>96/</sup> In July 2013, the U.S. Government Accountability Office ("GAO") issued a report in which it recommended that the SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls. The GAO's report concluded that "explicit disclosure would increase transparency and investor protection by making investors readily aware of whether a company has obtained an auditor attestation on internal controls. The disclosure could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions." See GAO, *Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation* (GAO-13-582) (July 3, 2013) at 37, available at <http://www.gao.gov/assets/660/655710.pdf>.

<sup>97/</sup> See PCAOB Release No. 2011-005 (July 12, 2011).

**C. Amendments to AU sec. 722**

AU sec. 722 includes a list of interim review procedures the auditor should perform when conducting a review of interim financial information. AU sec. 722 requires the auditor to "read and consider" the other information that accompanies the interim financial information and directs the auditor to consider AU sec. 550, which would be superseded by the proposed other information standard. AU sec. 722 would be amended to direct the auditor to consider the requirements of the proposed other information standard, if the auditor concludes that there is a material inconsistency, a material misstatement of fact, or both.

Questions Related to Section IX:

26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?
27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?

**X. Considerations Related to Audits of Brokers and Dealers**

As Exchange Act Rule 17a-5 ("Rule 17a-5") requires that audits of brokers and dealers be conducted in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014,<sup>98/</sup> the proposed other information standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits. At the publication date of the Board's proposal, the final SEC rules have not been published in the Federal Register.

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<sup>98/</sup> See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>. Citations in this Section are to SEC Rule 17a-5 under the Exchange Act, as revised in Exchange Act Release No. 70073.

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators annual audited financial statements on form X-17A-5.<sup>99/</sup> Form X-17A-5 includes, as part of the broker or dealer's filing, an oath or affirmation signed by an officer of the broker or dealer<sup>100/</sup> that the financial statements and supporting schedules<sup>101/</sup> are true and correct. Auditors of a broker's or a dealer's financial statements would read the oath or affirmation as part of the annual report filed with the SEC under the Exchange Act that contains audited financial statements and the related auditor's report, and evaluate the information in that oath or affirmation in accordance with the procedures in the proposed other information standard, as appropriate.

Rule 17a-5 also requires the broker or dealer to file a compliance report or an exemption report.<sup>102/</sup> The proposed other information standard would not apply to compliance or exemption reports by brokers or dealers as those reports and the related auditor reporting are addressed by *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*.<sup>103/</sup>

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of brokers and dealers. Many commenters who responded to this question in the concept release supported requiring the same reporting for all companies.

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<sup>99/</sup> See SEC Rule 17a-5 of the Exchange Act, 17 C.F.R. § 240.17a-5.

<sup>100/</sup> See SEC Rule 17a-5(e)(2) of the Exchange Act, 17 C.F.R. § 240.17a-5e2.

<sup>101/</sup> The proposed other information standard would not apply to supporting schedules required by Rule 17a-5. These schedules are addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*. See PCAOB Release No. 2011-005 (July 12, 2011).

<sup>102/</sup> See SEC Rule 17a-5(d)(1)(i)(A) and (B), 17 C.F.R. § 240.17a-5d1iA and B.

<sup>103/</sup> See *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*, PCAOB Release No. 2011-004 (July 12, 2011).

The Board received additional comments that were specific to audits of brokers and dealers from a small number of commenters. Some of those commenters suggested that the Board take into account the special characteristics of brokers and dealers in considering whether the changes to the auditor's report should apply to audits of brokers and dealers. One commenter on the concept release noted that amendments to Rule 17a-5 proposed by the SEC would provide users of brokers' and dealers' financial statements with sufficient information that would make additional auditor reporting unnecessary.

Question Related to Section X:

28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?

**XI. Considerations Related to Effective Date**

The proposed other information standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposals as well as the timing of Board adoption of any final standard and amendments. Additionally, some commenters suggested that, depending on the extent of changes to the auditor's report, the Board consider a delayed compliance date depending on the size of the company. The Board is seeking comment on whether any special consideration should be given to a delayed compliance date for the proposed other information standard, such as for the audits of smaller companies.

Questions Related to Section XI:

29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?
30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

## **XII. Considerations Related to Securities Act Documents**

The Board's proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information contained in an annual report that includes audited financial statements and related auditor's report filed under the Exchange Act; (2) specifying procedures for the auditor to perform with respect to evaluating this other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report of the results of the auditor's evaluation. The proposed other information standard would supersede AU sec. 550 and AU sec. 9550. The proposed other information standard would not apply to documents containing audited financial statements and the related auditor's report that are filed with the SEC under the Securities Act, which is consistent with the approach in AU sec. 550.

Currently, AU sec. 550 refers the auditor to AU sec. 711 with respect to the auditor's responsibilities for filings under the Securities Act.<sup>104/</sup> AU sec. 711 refers the auditor to the provisions of Section 11 of the Securities Act.<sup>105/</sup> Section 11 imposes liability, subject to a due diligence defense, for material misstatements and omissions in a registration statement on "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement . . . which purports to have been prepared or certified by him."<sup>106/</sup> Separately, Section 7 of the Securities Act<sup>107/</sup> requires issuers to file the consent of any accountant who is named as having prepared or

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<sup>104/</sup> See AU sec. 550.03. This paragraph also refers the auditor to AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties*, which provides guidance to auditors for performing and reporting on the results of engagements to issue letters (commonly referred to as "comfort letters") regarding the other information contained in registration statements filed with the SEC.

<sup>105/</sup> See AU sec. 711.02. See also AU sec. 711.03 regarding the auditor's responsibilities as an expert and the burden of proof that the auditor must meet under Section 11(b) of the Securities Act when the auditor's report is included in a registration statement.

<sup>106/</sup> 15 U.S.C. § 77k(a)(4).

<sup>107/</sup> 15 U.S.C. § 77g.

certified any part of the registration statement or any valuation or report included in the registration statement.

Audit procedures contained in AU sec. 711 require the auditor to read relevant portions of the prospectus to make sure that (1) the auditor's name is not being used in a way that indicates greater responsibility than intended, and (2) the prospectus does not imply that the financial statements have been prepared by the auditor.<sup>108/</sup> Additionally, auditors perform certain procedures described under AU sec. 711 to identify any subsequent events that may impact the auditor's report included in the company's registration statement from the date of the auditor's report up to or shortly before the effective date of the registration statement as part of conducting a "reasonable investigation" pursuant to Section 11 of the Securities Act.<sup>109/</sup> When a company's annual report on Form 10-K is incorporated by reference into a shelf registration statement on Form S-3, AU sec. 711 requires that the auditor perform procedures with respect to subsequent events to a date as close to the date of the filing of the Form 10-K as is reasonable and practicable in the circumstances.<sup>110/</sup>

As previously described in this release, the proposed auditor reporting standard and the proposed other information standard are intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. Specifically, the proposed other information standard would respond to investor's interests in obtaining information regarding the auditor's responsibilities for other information that is contained in documents that include the audited financial statements and the related auditor's report. The Board began considering the existing auditing standard on other information in documents containing audited financial statements, specifically AU sec. 550, as part of its effort to develop a

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<sup>108/</sup> See AU sec. 711.08.

<sup>109/</sup> See AU secs. 711.10-.11. See also AU secs. 711.12-.13 regarding the auditor's responsibilities if the auditor discovers or becomes aware of facts upon performing procedures subsequent to the date of the auditor's report.

<sup>110/</sup> See AU secs. 711.10-.11 and paragraph .07 of AU sec. 9711, *Filings Under Federal Securities Statutes: Auditing Interpretations of Section 711*. See also AU sec. 9711.05 regarding the auditor's responsibility to perform the procedures in AU secs. 711.10 and .11 when (1) a post-effective amendment to the shelf registration statement is filed as allowed under SEC Rule 430B of Regulation C, 17 C.F.R. § 230.430B or (2) an Exchange Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.



description in the auditor's report regarding the auditor's responsibilities for other information in certain documents filed with the SEC. Through that consideration, the Board determined that changes were appropriate to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

The Board considered proposing to extend the applicability of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act. However, the Board has identified obstacles to applying the reporting requirements under the proposed other information standard to documents filed under the Securities Act. For example, a company will file a registration statement on Form S-1 with the SEC containing information required under the Securities Act and SEC rules and regulations as well as the company's audited financial statements and the related auditor's report. The SEC may require the company to file several amendments to the Form S-1 to update the information disclosed in the registration statement before it is declared effective by the SEC. Under current Securities Act rules, the auditor's report is not required to be updated for amendments to the registration statement, unless certain circumstances occur.<sup>111/</sup> Rather, the auditor consents to the continued use of the auditor's report in the registration statement.<sup>112/</sup> The filing of the auditor's consent with the company's registration statement does not change the date or content of the auditor's report filed with the original registration statement. Because an auditor is not required to update the auditor's report prior to the effective date of the company's registration statement, the auditor's report contained in the registration statement would reflect only the evaluation performed under the proposed other information standard of the other information as of the date of the auditor's report and not reflect the auditor's procedures under AU sec. 711 between the date of the auditor's report and the effective date of the registration statement.

The Board recognizes that a similar obstacle with the proposed other information standard would apply in the case when a company files a registration statement and incorporates by reference information from the company's annual report previously filed with the SEC. For example, under the proposed other information standard, an auditor

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<sup>111/</sup> Under PCAOB standards, the auditor would be required to update the auditor's report under certain circumstances.

<sup>112/</sup> See SEC Rules 436 and 439 of Regulation C, 17 C.F.R. §§ 230.436 and 230.439.

would evaluate the other information contained in a company's annual report filed on Form 10-K and include a separate section in the auditor's report that stated the auditor's responsibilities for, and the results of, the auditor's evaluation of other information contained in the company's annual report. When the company later files a shelf registration statement on Form S-3 and incorporates by reference the company's previously filed annual report into the registration statement, the auditor would perform procedures on the other information contained in the shelf registration statement, as required under AU sec. 711. Similar to the reporting framework described above, the auditor is not required to update the auditor's report on the financial statement contained in the company's previously filed annual report that is incorporated by reference into the company's registration statement, but rather, the auditor consents to the continued use of the auditor's report.<sup>113/</sup> Therefore, the auditor's report that is part of the company's registration statement would reflect only the results of the auditor's evaluation under the proposed other information standard of the other information contained in the company's previously filed annual report and not reflect the auditor's procedures under AU sec. 711 on the portions of the shelf registration statement other than the previously filed annual report. As such, it is difficult to propose a meaningful auditor reporting requirement for the results of the auditor's evaluation of other information under the existing SEC reporting framework for Securities Act filings.

The Board acknowledges that investors and other financial statement users may believe that the auditor's level of involvement with, and related reporting on, other information in a document filed under the Securities Act, such as a registration statement for an initial public offering, should be no different than the auditor's responsibilities regarding other information contained in an annual report filed under the Exchange Act. The Board continues to assess whether it is possible to propose applying some of the elements of the proposed other information standard regarding the auditor's responsibilities over other information contained in documents filed under the Securities Act. For example, the Board considered proposing only the performance aspects of the proposed other information standard to Securities Act filings. However, the enhancements proposed in the other information standard were driven largely to enable auditor reporting on other information in annual reports filed under the Exchange Act. Additionally, the auditor already has responsibilities to perform procedures under AU sec. 711 for Securities Act filings. As such, the Board is requesting comments and information on the application of the proposed other information standard to Securities Act filings, including possible approaches to applying the reporting aspects of the proposed other information standard or the possible need for additional procedures regarding the auditor's responsibility for other information. The Board is particularly

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Id.

interested in receiving comments on whether or not additional procedures under AU sec. 711 are necessary or appropriate.

Questions Related to Section XII:

31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?
32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?
33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?

## **APPENDIX 7**

### ***Considerations Regarding Audits of Emerging Growth Companies***

#### **I. Introduction**

The Board is proposing two new standards and related amendments<sup>1/</sup> pursuant to its mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The proposed standards and amendments are intended to (1) increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report and (2) improve the auditor's procedures and enhance the auditor's responsibilities with respect to information outside the financial statements.

The Board's proposed auditor reporting standard would retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

Other proposed changes in the auditor's report would require a description of certain of the auditor's responsibilities, such as the auditor's responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The proposed auditor reporting standard

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<sup>1/</sup> The Board's proposals include: (1) Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"); (2) Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"); and (3) related proposed amendments to PCAOB standards (the "proposed amendments"). The Board's proposals are also referred to collectively as the "proposed standards and amendments."

also would add to the auditor's report new information regarding the audit and the auditor, such as statements about the auditor's responsibility to be independent, the length of the auditor's tenure as the company's auditor, and the auditor's responsibilities for, and the results of, the auditor's evaluation of information outside the financial statements.

As more fully described in the Release and Appendix 5, the Board is proposing an approach that it believes would increase the relevance and informational value of the auditor's report, including by requiring the auditor to provide specific insight into the audit of the company's financial statements.<sup>2/</sup> The proposed approach would be aligned with the Board's mission and is intended to be implemented in a cost-effective way. For example, because critical audit matters are determined based on the relative complexity and difficulty of the audit, the Board anticipates that the proposed auditor reporting standard would be scalable based on the size, nature, and complexity of the audit of the company. The Board also anticipates, however, that some of the enhanced basic elements and communication of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees.<sup>3/</sup>

The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to "other information," that is, information other than the audited financial statements and the auditor's report, in a company's annual report filed with the U.S. Securities and Exchange Commission ("SEC" or "Commission") under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed enhancements to the required auditor's procedures are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. As a result of the linkage between the proposed auditor reporting standard and the proposed other information standard, investors and other financial statement users would obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description

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<sup>2/</sup> The Board's approach to increase the relevance and informational value of the auditor's report is discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*; V., *Critical Audit Matters*; and VI., *Explanatory Language*.

<sup>3/</sup> The potential costs related to the proposed auditor reporting standard are discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*, and V.F., *Other Considerations for Critical Audit Matters*.

of the results of the auditor's evaluation based on the auditor's procedures on the other information.

As described in the Release and Appendix 6, the required procedures under the proposed other information standard are intended to provide consistency and improve the auditor's evaluation of other information, which could be of importance to investment decision making.<sup>4/</sup> The Board believes that the proposed approach to the auditor's responsibilities for other information would be scalable to less complex companies, based on the nature and extent of the information outside the financial statements for such companies as compared to companies with more extensive operations. The Board, however, also anticipates that the proposed other information standard would have cost implications for auditors and companies, including audit committees.<sup>5/</sup>

In developing the proposed standards and amendments, the Board considered (1) the information communicated in the current auditor's report; (2) the potential benefits that may result from auditors providing additional communications; (3) the potential costs related to the approach proposed by the Board; (4) alternative approaches; (5) current developments in similar projects by other standard setters;<sup>6/</sup> (6) relevant academic research; and (7) significant comments received by the Board from its outreach efforts. In considering the nature and extent of changes to the existing

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<sup>4/</sup> The Board's approach to improve the auditor's evaluation of other information is discussed more fully in Appendix 6, specifically Sections III., *Evaluating the Other Information*; and V., *Responding When the Auditor Determines That There is a Potential Misstatement in the Audited Financial Statements*.

<sup>5/</sup> The potential costs related to the proposed other information standard are discussed more fully in Appendix 6, specifically Sections III.C.3., *Performing Procedures to Evaluate the Other Information*; VI., *Reporting in the Auditor's Report*, and VIII., *Other Considerations*.

<sup>6/</sup> The International Auditing and Assurance Standards Board ("IAASB") has similar projects related to changes to the auditor's report and the auditor's responsibilities regarding other information. In addition, there are a legislative proposal by the European Commission ("EC") and a subsequent European Parliamentary report that relate to audits of public interest entities. Most recently, the United Kingdom's Financial Reporting Council ("FRC") adopted revisions to its auditor reporting standard. The IAASB's projects, the EC's proposal and subsequent report, and the FRC's revised standard would require auditor reporting on certain additional matters.



auditor's report and the auditor's responsibilities for other information, the Board sought to respond to the needs of investors and other financial statement users by making the auditor's report more informative while not adding unnecessary burden to the financial reporting process.

## **II. Statutory Background**

The Board is considering the proposed standards and amendments pursuant to its authority under the Sarbanes-Oxley Act of 2002 ("Act").<sup>7/</sup> If ultimately approved by the Board, the proposed standards and amendments will be filed for approval by the Commission. Pursuant to Section 107(b)(3) of the Act, the Commission shall approve a proposed standard if it finds that the standard is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

The Act was amended by Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act")<sup>8/</sup> to provide that any additional rules adopted by the Board subsequent to April 5, 2012 do not apply to the audits of "emerging growth companies" ("EGCs")<sup>9/</sup> unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of

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<sup>7/</sup> Pub. L. No. 107-204. Pursuant to Section 101 of the Act, the mission of the Board is to oversee the audits of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. See Pub. L. No. 111-203. The term "registered broker or dealer" is defined in Section 3(a)(48) of the Exchange Act.

<sup>8/</sup> Pub. L. No. 112-106 (April 5, 2012).

<sup>9/</sup> Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

investors and whether the action will promote efficiency, competition, and capital formation.<sup>10/</sup>

In addition, the JOBS Act specified that "[a]ny rules of the Board requiring...a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company...".<sup>11/</sup> The proposed standards and amendments, if adopted, will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs. Before adoption, the proposed standards and amendments will be subject to an evaluation as to whether the Board should recommend to the SEC that the proposed standards and amendments be applicable to the audits of EGCs and the SEC will make a separate determination regarding the applicability of the proposed standards and amendments to the audits of EGCs. At this time no determination has been made about the applicability of the proposed standards and amendments to the audits of EGCs.

This Appendix contains a discussion of considerations relating to EGCs and includes data on EGCs. This Appendix also includes specific questions and requests relevant information, including potential costs, and empirical data, to the extent available to commenters, regarding the potential application of the proposed standards and amendments to the audits of EGCs. Commenters providing cost estimates are requested to provide the basis for any estimate provided. The Board is requesting commenters' views on the applicability of the proposed standards and amendments to the audits of EGCs and responses to specific questions in order to provide information to enable the Board to assist the SEC in making its determination regarding the applicability of the proposed standards and amendments to the audits of EGCs.

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<sup>10/</sup> See Section 103(a)(3)(C) of the Act, as added by Section 104 of the JOBS Act.

<sup>11/</sup> Id. An auditor's discussion and analysis ("AD&A") currently does not exist in auditing standards but was described as one of several conceptual alternatives for changing the auditor's reporting model in the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "concept release"), PCAOB Release No. 2011-003 (June 21, 2011). Section IV.A., *Auditor's Discussion and Analysis*, of this Release describes an AD&A and related comments received on the concept release.

The Board's Release, as well as Appendices 5 and 6, provide related information regarding the proposed standards and amendments, including discussions of the following areas (1) the background of and reasons for the proposed standards and amendments; (2) the Board's approach, including consideration of alternatives; (3) key changes and improvements from existing requirements; and (4) potential costs related to the proposed standards and amendments. Economic considerations related to the proposed standards and amendments are noted in the Release and this Appendix, with Appendices 5 and 6 providing further discussion regarding the economic considerations related to each proposed standard.

### **III. Characteristics of Self-Identified EGCs**

The PCAOB has begun to monitor implementation of the JOBS Act in order to better understand the characteristics of EGCs<sup>12/</sup> and inform the Board's considerations regarding whether it should request that the SEC apply the proposed standards and amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.<sup>13/</sup>

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<sup>12/</sup> In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 ("Securities Act") did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the issuer retains its EGC status until the earliest of: (1) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (2) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (3) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three-year period; or (4) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, a company that has been public for at least one year and has an equity float of at least \$700 million). See Section 3(a)(80) of the Exchange Act.

<sup>13/</sup> To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and May 15, 2013, for disclosures by companies related to their EGC status. Companies with filings indicating that they are no longer EGCs are not included in this analysis. Any filings subsequent to May 15, 2013 are not included in this analysis. The PCAOB has not validated these companies' self-identification as EGCs. The information presented also does not include data for

As of May 15, 2013, based on the PCAOB's research, 909 SEC registrants have identified themselves as EGCs in SEC filings.

These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are: blank check companies; pharmaceutical preparations; real estate investment trusts; prepackaged software services; and computer processing/data preparation services.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are: federally chartered savings institutions; real estate investment trusts; national commercial banks; state commercial banks; and natural gas transmission. Total assets of EGCs in these five SIC codes represent approximately 42% of the total assets of the population of EGCs. EGCs in three of these five SIC codes represent financial institutions (that is, federally chartered savings institutions, national commercial banks, and state commercial banks) and the total assets for these three SIC codes represent approximately 28% of the total assets of the population of EGCs.

A majority of the companies that have identified themselves as EGCs have begun reporting information under the securities laws since 2012. Of these companies, approximately:

- 25% identified themselves in registration statements and were not reporting under the Exchange Act as of May 15, 2013.
- 55% of the companies that have identified themselves as EGCs began reporting under the Exchange Act in 2012 or later.
- 20% of the companies have been reporting under the Exchange Act since 2011 or earlier.

Approximately 20% of these companies have securities listed on a U.S. national securities exchange as of May 15, 2013.

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companies that have filed confidential registration statements and have not subsequently made a public filing.

Approximately 65% of the companies that have identified themselves as EGCs and filed an Exchange Act filing indicated that they were smaller reporting companies.<sup>14/</sup>

Audited financial statements were available for nearly all of the companies that have identified themselves as EGCs.<sup>15/</sup> For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of May 15, 2013:

- The reported assets ranged from zero to approximately \$18.2 billion. The average and median reported assets were approximately \$183.7 million and approximately \$0.3 million, respectively.<sup>16/</sup>
- The reported revenues ranged from zero to approximately \$959.1 million. The average and median reported revenues were approximately \$56.3 million and zero, respectively.

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<sup>14/</sup> The SEC adopted its smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 8876 (Dec. 19, 2007). Generally, companies qualify to be smaller reporting companies and, therefore, have scaled disclosure requirements if they have less than \$75 million in public equity float. Companies without a calculable public equity float will qualify if their revenues were below \$50 million in the previous year.

<sup>15/</sup> Audited financial statements were available for 897 of the 909 self-identified EGCs. Audited financial statements were not available for some EGCs that have filed registration statements that have not been declared effective.

<sup>16/</sup> For purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 were approximately \$12.1 billion and approximately \$1.5 billion, respectively. The average and median reported revenues from the most recent audited financial statements filed as of May 15, 2013 of issuers in the Russell 3000 were approximately \$4.6 billion and \$717.2 million, respectively.

- The average and median reported assets among companies that reported revenues greater than zero were approximately \$365.8 million and \$59.9 million, respectively. The average and median reported revenues among companies that reported revenue greater than zero were approximately \$113.5 million and \$17.2 million, respectively.
- Approximately 48% identified themselves as "development stage entities" in their financial statements.<sup>17/</sup>
- Approximately 35% were audited by firms that are annually inspected by the PCAOB (that is, firms that have issued audit reports for more than 100 public company audit clients in a given year) or are affiliates of annually inspected firms. Approximately 65% were audited by triennially inspected firms (that is, firms that have issued audit reports for 100 or fewer public company audit clients in a given year) that are not affiliates of annually inspected firms.
- Approximately 55% had an explanatory paragraph included in the auditor's report on their most recent audited financial statements describing that there is substantial doubt about the company's ability to continue as a going concern.<sup>18/</sup>

Approximately 40% of the self-identified EGCs that provided a management report on internal control over financial reporting stated in the report that the company's internal control over financial reporting was not effective.<sup>19/</sup>

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<sup>17/</sup> According to Financial Accounting Standards Board ("FASB") standards, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification, Subtopic 915-10, Development Stage Entities – Overall.

<sup>18/</sup> Approximately 1% of the population of companies in the Russell 3000 Index have an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern.

<sup>19/</sup> Approximately 4% of the population of companies in the Russell 3000 Index provided a management report on internal control over financial reporting stating that the company's internal controls over financial reporting were not effective.



The JOBS Act includes a provision that allows Securities Act registration statements of EGCs to include two years of audited financial statements instead of three years for the initial public offering of common equity securities. Approximately 750 of the self-identified EGCs would not be required to present more than two years of financial statements regardless of the JOBS Act relief.<sup>20/</sup> Approximately 75% of the remaining portion of the EGC population have opted out of the provision by providing in their registration statements audited financial statements for three years instead of two. Some of the EGCs that opted out of this provision described in their filings risks related to taking advantage of some of the JOBS Act provisions. Risks described included the company's common stock becoming less attractive to investors and their financial statement disclosures not being comparable to those of similar companies.

#### **IV. Economic Considerations**

The economic considerations summarized below are addressed in the Release, Appendix 5, and Appendix 6, and could apply to both small and large companies. A number of these considerations are relevant to efficiency, competition, and capital formation.

##### **A. Proposed Auditor Reporting Standard**

The proposed auditor reporting standard would require the auditor to communicate in the auditor's report critical audit matters. Critical audit matters ordinarily are matters of such importance in the audit that they would be included in the matters required to be (1) documented in the engagement completion document under Auditing Standard No. 3, *Audit Documentation*; (2) reviewed by the engagement quality reviewer under Auditing Standard No. 7, *Engagement Quality Review*; (3) communicated to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees* or other PCAOB standards; or (4) any combination of the three. Thus, the proposed auditor reporting standard is intended to leverage the work the auditor already performed when conducting an audit under the Board's existing standards and does not impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

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<sup>20/</sup> Some EGCs (1) are already afforded such relief as smaller reporting companies, (2) have existed for less than three years, (3) follow the reporting requirements of development stage entities which require an income statement since inception, or (4) have not filed a Securities Act registration statement yet, and thus have not availed themselves of this relief.

The Board believes that auditor reporting linked to matters identified during the audit that involved the most difficult judgments or the most difficulty in obtaining evidence or forming the opinion is responsive to the requests of many investors for information that should provide a greater degree of insight into the audit. Communication of critical audit matters is expected to result in information specific to each audit of a company's financial statements, and would highlight important aspects of the audit.

Additionally, the proposed auditor reporting standard would add to the auditor's report new information regarding the audit or the auditor, such as statements about the auditor's responsibility to be independent, the length of the auditor's tenure as the company's auditor, and the auditor's responsibilities for, and the results of, the auditor's evaluation of information outside the financial statements. This new information generally would be standardized language about the audit or the auditor and would be the same or very similar among different auditors' reports.

The proposed auditor reporting standard retains from the existing standard<sup>21/</sup> the use of explanatory paragraphs in the auditor's report, including the auditor's ability to emphasize a matter regarding the financial statements.

The Board also anticipates that some of the enhanced basic elements and communication of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees, such as:<sup>22/</sup>

- One-time costs that relate primarily to updating an audit firm's methodology and training regarding auditor reporting for basic elements and critical audit matters. Additionally, the auditor may incur some initial costs to determine the year the auditor began serving consecutively as the company's auditor;
- Recurring costs in each individual audit relative to the determination, communication in the auditor's report, and documentation of critical audit matters; and

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<sup>21/</sup> AU sec. 508, *Reports on Audited Financial Statements*.

<sup>22/</sup> The potential costs related to the proposed auditor reporting standard are discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*, and V.F., *Other Considerations for Critical Audit Matters*.

- Recurring costs for the company, including the audit committee, for reviewing the critical audit matters included in the draft auditor's report.

There could be potential unintended consequences associated with requiring auditors to communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit, which might reduce the time available to the auditor to review and complete the audit work.

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry<sup>23/</sup> that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.<sup>24/</sup>

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the quality of the information<sup>25</sup> in the financial statements. Academic research has indicated that

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<sup>23/</sup> Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

<sup>24/</sup> See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553, 1553-1583 (2004).

<sup>25/</sup> The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a

increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.<sup>26/</sup>

Auditor's reports that include critical audit matters would be specific to the audit of the company. Therefore, auditors' reports would be different between the company's current period critical audit matters and those of prior periods or those of the company's competitors. Some investors have commented that they are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditors' reports among companies and reporting periods. Critical audit matters, however, would not necessarily include all the information important to an investment decision.

Additionally, as critical audit matters in the auditor's report would not be something that investors and other financial statement users are accustomed to reviewing or analyzing, investors and other financial statement users could misunderstand a critical audit matter or the meaning of a critical audit matter. However, as financial statement disclosures have changed over time, investors and other financial statement users are accustomed to reviewing or analyzing new or different information. Therefore, such users should have the ability to interpret the meaning of critical audit matters communicated in an auditor's report.

Some comments regarding alternatives presented in the concept release indicated that more information about the audit in the auditor's report could lead to more efficient pricing of equity securities, either through changes in expected future earnings or changes in the discount rate used to value future earnings, or both.

As previously noted, the Board anticipates that the communication of critical audit matters would result in auditor's reports that could vary significantly – both among companies and reporting periods. Academics that conducted a study of financial

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signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 *Journal of Accounting Research* 1, 1-42 (1982).

<sup>26/</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1-29 (2011).

analysts to assess how they use an auditor's report as part of a company evaluation found that the variability of information content would mean that the information would not be just confirming prior beliefs about financial statement quality but would be more likely to affect user decision making and increase the perceived quality of the audit.<sup>27/</sup>

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.<sup>28/</sup> Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. Making the auditor's report more informative can benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the amount or quality of the information in the financial statements. Academic research has indicated that increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.<sup>29/</sup>

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<sup>27/</sup> See Paul J. Coram, Theodore J. Mock, Jerry L. Turner, and Glen L. Gray, *The Communicative Value of the Auditor's Report*, 58 *Australian Accounting Review* 235, 235-252 (2011).

<sup>28/</sup> See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 *Journal of Accounting and Economics* 337, 337-386 (2003).

<sup>29/</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1-29 (2011).

## **B. Proposed Other Information Standard**

The proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information; (2) including specific procedures for the auditor to perform with respect to evaluating the other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report.

The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors. The proposed other information standard includes specific procedures designed to improve the auditor's evaluation of the other information. These procedures are intended to provide consistency in practice among auditors when evaluating the other information or responding to material inconsistencies or material misstatements of fact identified in the other information. These proposed procedures also are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. The Board, however, also anticipates that the proposed other information standard would have some cost implications for auditors and companies, including audit committees, such as:<sup>30/</sup>

- One-time costs, for example, updating audit firm methodologies to reflect the new performance and reporting requirements and training firm personnel;
- Recurring costs related to increased auditor effort to evaluate the other information, particularly for firms that might not currently be performing evaluation procedures on the other information similar to those in the proposed other information standard;

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<sup>30/</sup> The potential costs related to the proposed other information standard are discussed more fully in Appendix 6, specifically Sections III.C.3., *Performing Procedures to Evaluate*; VI., *Reporting in the Auditor's Report*; and VIII., *Other Considerations*.



- Costs for the auditor related to situations in which a material inconsistency or a material misstatement of fact is identified, including costs related to performing procedures to respond to, and report on, such material inconsistency, material misstatement of fact, or both,<sup>31/</sup> and
- Costs that might also arise for the company and its audit committee as a result of additional discussions with the auditor and others in connection with the description in the auditor's report.

The enhanced reporting requirements regarding other information are designed to provide investors and other users of financial information with an understanding of the auditor's responsibilities related to the other information as well as the results of the auditor's evaluation of the other information.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's financial statements and on the identification of material misstatements of fact. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,<sup>32/</sup> or intentional misreporting.<sup>33/</sup> As a result of the auditor's evaluation of other information and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the

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<sup>31/</sup> Costs related to reporting under the proposed other information standard regarding a material inconsistency should be similar to those incurred under the existing standard because the requirements of the two standards are similar in this respect.

<sup>32/</sup> See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 *Journal of Accounting and Economics* 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting*, Unpublished working paper (2013) available at <http://ssrn.com/abstract=929731>.

<sup>33/</sup> See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 *Journal of Accounting Research* 1135, 1135-1166 (2009).

proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information<sup>34/</sup> available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors could also facilitate more efficient capital allocation decisions.<sup>35/</sup> Academic research has shown that the increased quality of information could also result in a reduction in the average cost of capital.<sup>36/</sup>

**V. Request for Comment on the Applicability of the Proposed Standards and Amendments to Emerging Growth Companies**

The Board is in the process of considering how the proposed standards and amendments might affect audits of EGCs.

Based on the data outlined in Section III, *Characteristics of Self-Identified EGCs*, above, EGCs generally appear to be smaller and newer public companies. Although it may be often assumed that such companies would have operations, and respectively audits, that are less complex, this may not be true for many EGCs.

As noted in Section III above, financial institutions represent approximately 28% of the total assets of EGCs. Given the nature of the operations of financial institutions, the audits of these EGCs might involve subjective or complex areas, such as the auditor's evaluation of the determination of the allowance for loan losses or the valuation of financial instruments with little market activity. Therefore, in the audits of these EGCs, the auditor might be addressing matters that meet the definition of critical audit matters because they involved difficult, subjective, or complex auditor judgments.

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<sup>34/</sup> See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 *Journal of Accounting Research* 1, 1-42 (1982).

<sup>35/</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1-29 (2011).

<sup>36/</sup> Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, see Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of Information Precision in Determining the Cost of Equity Capital*, 9 *Review of Accounting Studies* 233, 233-259 (2004).

The data presented in Section III above also suggests that EGCs are 10 times more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective. As a result, in the audits of EGCs, the auditor might be presented with control deficiencies of high severity which likely would be a consideration in the auditor's determination of critical audit matters because the control deficiencies might, for example, pose difficulty to the auditor in obtaining sufficient appropriate audit evidence.

Further, the data presented in Section III above indicates that for 55% of the EGCs the auditor's report on the most recent audited financial statements includes an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern, as compared to 1% for the population of companies in the Russell 3000 Index. This suggests that for the majority of EGCs the auditor is evaluating whether there is substantial doubt about the company's ability to continue as a going concern. Depending on the facts and circumstances, the auditor's evaluation might meet the definition of critical audit matters.

As described in Section III above, a review of SEC filings of EGCs indicates that three quarters of the EGCs that could have taken advantage of a JOBS Act provision to present two years of financial statements in their registration statements have chosen not to avail themselves of this provision and instead presented three years, which is generally required of non-EGC companies. Discussion included in EGC filings suggests that taking advantage of JOBS Act provisions that allow more limited disclosures in a company's filings is viewed by at least some EGCs as presenting risks that they are unwilling to take.

The application of the proposed auditor reporting standard, specifically the requirement to communicate critical audit matters, may be beneficial to EGCs because critical audit matters would provide more information about the company's audit to investors and other financial statement users. In general, there is less information available in the market about smaller and newer companies than there is about larger, more established companies. For example, smaller companies have very little, if any, analyst coverage which lessens the entire mix of information made available to investment bankers, fund managers, and individual investors which makes markets less efficient.<sup>37/</sup> The communication of critical audit matters would provide more information

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<sup>37/</sup> See SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission*, (April 23, 2006) at 73, available at <http://www.sec.gov/info/smallbus/acspc.shtml>.

to investors and provide insight about the most difficult, subjective, or complex matters that the auditor addressed in the audit. Providing meaningful information about the audit, such as the communication of critical audit matters in the auditor's report, could thus be particularly beneficial to smaller and newer companies. The availability of such information could contribute toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital.

As noted in Section III above, many EGCs have identified themselves as smaller reporting companies. Smaller reporting companies generally apply the SEC's scaled disclosure rules.<sup>38/</sup> Therefore, these companies have less other information for the auditor to evaluate under the proposed other information standard than larger companies. Thus, EGCs that are smaller reporting companies may incur less cost related to the evaluation of the other information than larger companies.

As the Board's considers whether it should request the SEC to apply the proposed standards and amendments to the audits of EGCs, the Board reviewed relevant comments received in response to the concept release and from the Board's Standing Advisory Group ("SAG"). The concept release, which was issued before the JOBS Act became law, included a question about whether the changes to the auditor's reporting model should apply 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. Commenters diverged on whether certain types of companies should be excluded from the scope of changes to the auditor reporting model.

Some commenters that responded to this question in the concept release suggested that, depending on the nature and extent of changes to the auditor's report, the Board give different consideration to the auditors' reports of smaller companies, which would include many EGCs. Suggested examples of such considerations include a phased-in implementation depending on the size of the company; application of any new requirements only to larger companies followed by consideration of expanding the requirements to smaller companies; and total exemption for companies under certain market capitalization. The reasons for the suggested different considerations include

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<sup>38/</sup> The SEC adopted a new system of disclosure rules for smaller reporting companies. The new rules were effective February 4, 2008. They are scaled to reflect the characteristics and needs of smaller companies and their investors. See SEC, *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 8876 (Dec. 19, 2007).

greater cost constraints typically experienced by smaller companies; differences in corporate structure, complexity, and the types of users of smaller companies' financial information; and statutory exemptions for certain smaller companies from the requirement for an auditor's report on internal control over financial reporting.

In contrast, other commenters that responded to this question in the concept release supported requiring the same reporting for all companies regardless of nature or size. The primary reason of these commenters' views was better consistency and comparability of auditors' reports across companies.

Likewise, some participants at the May 2012 SAG meeting commented that they do not support the development of separate auditing standards for EGC and non-EGC public companies because it would be very difficult for the auditor to apply an "on/off switch" with respect to the auditor's responsibilities.<sup>39/</sup> Those participants described a differential approach to EGCs as challenging and resulting in unnecessary complications for audits of EGCs. These participants did not clarify whether their comments relate to audit performance standards, reporting standards, or both. This concern of having different auditing standards for EGCs may be mitigated to the extent that reporting on critical audit matters is a discrete and separable task.

As noted previously, approximately 65% of EGCs were audited by triennially inspected firms that are not affiliated with annually inspected firms. Approximately 76% of triennially inspected firms audit 10 or fewer issuers<sup>40/</sup> which could indicate that these are small firms with more limited resources. Therefore, developing and maintaining different methodologies for audits of EGCs and non-EGCs, as well as the related staff training, could have a disproportionately negative effect on triennially inspected firms because of higher costs in relation to their income.

Exempting EGCs from the proposed standards and amendments might put them at an informational disadvantage compared to larger and more established companies that would be subject to the proposed standards and amendments. For example, if the

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<sup>39/</sup> See May 2012 SAG meeting available at [http://pcaobus.org/News/Webcasts/Pages/05172012\\_SAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/05172012_SAGMeeting.aspx).

<sup>40/</sup> See Exhibit 1 of *Report on 2007-2010 Inspections of Domestic Firms That Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013-001 (Feb. 25, 2013) available at [http://pcaobus.org/Inspections/Documents/02252013\\_Release\\_2013\\_001.pdf](http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf).

standards do not apply to audits of EGCs, but are applicable to audits of larger and more established companies, the potential disparity between the two groups of companies in the amount and quality of public information available for investment decision making could increase. To the extent that market participants perceive adoption of the proposed standards and amendments as a step toward lowering information asymmetry between company management and investors, exempting EGCs from the proposed standards and amendments may also put them at a disadvantage. Exempting EGCs from the proposed standards and amendments could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a competitive disadvantage compared to non-EGCs in attracting available capital.

The Board is interested in commenters' views on the impact of the proposed standards and amendments on audits of EGCs. The Board is soliciting comments generally on issues it should consider relating to the applicability of the proposed standards and amendments to EGCs, as well as responses to the specific questions below.

Questions:

1. Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?
2. Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?
3. Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?
4. Would audits of EGCs be more, less, or equally likely to have critical audit matters?
5. Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?
6. What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?



7. What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?
8. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?
9. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?
10. For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?