PCAOB Proposals Would Significantly Expand Auditor Responsibility

September 10, 2013

The PCAOB **recently proposed two auditing standards** in an effort to improve the auditor's report that accompanies annual financial statements: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. The proposals follow earlier concept releases by the PCAOB and are part of an effort to make the auditor's report more useful, rather than being a mere "pass/fail" report on the financial statements.

Most notably, the proposals would require the auditor to make an express statement, within its audit report, as to the absence of material misstatements in a company's annual report (for both U.S. and foreign issuers registered with the SEC), including in all the non-financial statement information, or "other information." The auditor must also make similar conclusions in connection with the auditor's review of quarterly reports (for U.S. issuers). In addition, the proposals would require the auditor to include in its audit report "critical audit matters" pertaining to areas where the auditor encountered the most difficulty during the audit.

In its release, the PCAOB indicates that the proposals are an attempt to address investor and other financial statement users' dissatisfaction with the existing audit report. In particular, the PCAOB points to investor feedback that supports greater transparency about the audit and how it is conducted with respect to a company.

We believe that the proposals have the potential to significantly increase the cost and length of audits. These costs and delay would come without any meaningful benefits beyond those provided by the existing regulatory framework, which already includes checks to ensure the consistency and accuracy of the financial statements and related disclosure.

Expanded Scope of Audit Report to Cover "Other Information"

The proposals would require the auditor to affirmatively comment on "other information," defined as information that accompanies financial statements in an annual report filed with the SEC that includes the company's audited financial statements. "Other information" includes all other information in the filing – not simply financial-related sections such as the Management's Discussion & Analysis, but even discussions of risk factors, the business and executive compensation, including the compensation discussion and analysis. The following language would be required to describe the auditor's evaluation and its results:

> "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."

The proposals would also require the auditor, as part of its quarterly review procedures, to make a similar determination about "other information" in a quarterly report.

The PCAOB indicates that the auditor's evaluation of "other information" and communication of its findings could promote consistency among the "other information" and audited financial statements, and that auditors must already review and consider such other information in their audits. While that is true, we believe that auditors will need to consider the potential liability involved in providing, in their audit report, an affirmative statement about the absence of material misstatements of fact and will in fact expand their audit procedures, leading to significantly higher costs and lead times for audits and quarterly reviews, and coming after the deadlines for annual and quarterly filings have been shortened in recent years. In addition, auditors may be less willing to defer to determinations of materiality by management, disclosure and audit committees and counsel, given the need to make this statement over their own signature.

While the proposed rules will lead to increased costs and delay, we note that current laws and SEC regulations (enhanced through the Sarbanes-Oxley Act) already require CEO and CFO certifications of disclosure required in annual and quarterly reports, as well as the establishment of disclosure controls, and that NYSE and NASDAQ listing rules require independent audit committee supervision of annual and quarterly reports. These procedures are generally viewed as rigorous and effective. Moreover, in our experience, investors and analysts would not generally be expecting, or looking to, the auditors to verify non-financial information included in an SEC filing, but would expect it to be verified by the company, through its disclosure committee, audit committee and management certification process. Accordingly, we believe the incremental costs would provide little benefit.

Expanded Disclosures: Critical Audit Matters

The proposals would also require the auditor to communicate in its audit report "critical audit matters," defined as "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements." The PCAOB indicates that "critical audit matters" would be derived from, and constitute a subset of, issues currently identified in the engagement completion document, communicated to the engagement quality reviewer or communicated to the audit committee. The proposed disclosure would require identification of the "critical audit matters;" describe the considerations that resulted in the determination that a "critical audit matter" existed; and refer to the relevant financial statement accounts and disclosures that relate to the "critical audit matters," when applicable.

We note that this proposal too is likely to add to the time and cost of audits and to significantly lengthen audit reports. The proposal's requirement to discuss critical auditing matters could lend itself to second-guessing of auditors in hindsight (if a restatement later occurs), and auditors might opt to include significant disclosures, including about significant deficiencies in internal controls, complex accounting judgments and any other matters that could lead to potential restatement.

It is further unclear to us what benefit, if any, financial statement users would reap from the disclosure of these "critical audit matters" in addition to the existing disclosure of critical accounting policies already required in annual and quarterly reports.

Expanded Disclosures: Auditor Specific Information

The proposals would also require disclosure of the following information regarding the auditor: (1) a statement regarding the auditor's independence; and (2) the year the auditor began serving as the company's auditor. While these statements do not provide much added information to investors, we do not view them as potentially problematic expansions of the audit report.

Comment Period; Effectiveness

The PCAOB is soliciting comments related to the proposals until December 11, 2013. Subject to final approval by the PCAOB and the SEC, the proposals would be effective for financial statement audits for fiscal years beginning on or after December 15, 2015.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Alan F. Denenberg	**650 752 2004**	**alan.denenberg@davispolk.com**
Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
Thomas J. Reid	**212 450 4233**	**tom.reid@davispolk.com**
Richard J. Sandler	**212 450 4224**	**richard.sandler@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**
Sarah Ashfaq	**212 450 4246**	**sarah.ashfaq@davispolk.com**