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PCAOB Proposes to Change Auditors' Reports

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Yesterday, the PCAOB **proposed** for public comment new auditing standards on the auditor's report filed with the company annual report containing financial statements, generally the Form 10-K. Comments are due by December 11, 2013. The PCAOB indicated that the groundwork for these changes began in 2010 and 2011, culminating in a concept release that was issued in June 2011. An idea raised in the concept release to include an "auditor's discussion and analysis" to the report has been rejected.

The proposed standard retains the current "pass/fail" model because the auditor will continue to opine on whether the financial statements are fairly presented (pass) or not (fail), but would also require the communication of critical audit matters that would be specific to each audit, or would state that no such critical matters existed. 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.

These matters would likely come from the engagement completion document, which summarizes the significant issues and findings from the audit, would be reviewed by the engagement quality reviewer and/or would be communicated to the audit committee. If critical audit matters need to be included in the auditor's report, then the report would identify the 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 matter.

The report would also add new elements to the auditor's report related to auditor independence and auditor tenure. Lengthy auditor tenure has been raised by some activists as calling into question the auditor's independence. Under this proposal, the auditor would be required to disclose the year in which it began serving as the company's auditor.

An auditor's responsibility for "other information" is also proposed to be expanded. "Other information" is defined as information included in the Form 10-K, other than the financial statements and auditor's report. This would include the MD&A, exhibits and items incorporated by reference. Currently, the auditor must "read and consider" this information against the financial statements. Under the proposal, the auditor will be required to perform additional procedures, evaluate the other information for material misstatements or material inconsistency with the financial statements and communicate the auditor's evaluation. The auditor's evaluation would not require procedures on the portions of the disclosure, primarily non-financial information, that are not directly related to the financial statements and that were not required to be obtained during the audit. However, the PCAOB recognized that this particular proposal will likely add costs to the audit.

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

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