PCAOB Proposes Significant Changes to Auditor’s Report
and Responsibilities for Annual Reports Filed With the SEC

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Background

As a result of ongoing efforts to improve the informational value of the auditor’s reporting model, on August 13, 2013 the Public Company Accounting Oversight Board (PCAOB) proposed two new auditing standards for public comment that would expand the scope of the auditor’s report on a company’s audited financial statements and require the auditor to perform an evaluation of other information included in the company’s annual report filed with the SEC. The comment period for these proposed standards and related amendments ends on December 11, 2013. 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 proposed standards would:

- require the audit report to disclose and describe “critical audit matters” that were specifically examined by the auditor during the audit;
- require the auditor to report on “other information” that is outside of the audited financial statements but is included in the annual report filed with the SEC under the Securities Exchange Act of 1934; and
- add elements to the audit report relating to auditor tenure and the auditor’s independence from the issuer.

The PCAOB did not, however, propose any standards regarding the inclusion of an auditor’s discussion and analysis in the auditor’s report, an approach that the PCAOB had raised in its June 2011 Concept Release.

New Standard on Disclosure of Critical Audit Matters

This new audit standard would retain the existing, binary (or pass/fail) form of the audit report which provides an opinion that the audited financial statements do or do not fairly present the financial condition of the issuer, but also would require the communication of critical audit matters as determined by the auditor. The communication of critical audit matters may provide investors and other users of financial reports with insight on how the auditor reached its conclusions. The auditor would be required to disclose and describe the matters that:

- 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.

These critical audit matters have been described by some commentators and PCAOB members as those matters that “kept the auditor awake at night.” Under the proposal, if critical audit matters are disclosed, the auditor would be required to describe the considerations or reasons that led the matter to be identified as critical and refer to the relevant financial statement accounts and disclosures that relate to the critical matter, when applicable.

If adopted, this proposal likely would make public some discussions that traditionally have been kept private between the audit committee and the auditor. The proposal reflects a global trend: last month, the International Auditing and Assurance Standards Board exposed for public comment a similar proposal, requiring auditors to report “Key Audit Matters.”

Auditor’s Obligation to Evaluate the “Other Information”

Under this proposed standard, auditors would be required to perform an evaluation of, and report on, information outside of the audited financial statements that is included in a company’s annual report filed with the SEC. This proposed standard would expand the auditor’s existing responsibility to read and consider the “other information” included in the annual report. This “other information” would include management’s discussion and analysis of financial condition and results of operations, exhibits to the annual report, and items incorporated by reference. Auditors would be required to read and evaluate this information, and would be required to perform additional procedures to determine whether the “other information” contains a material misstatement of fact or a material inconsistency with amounts or information in the audited financial statements. The auditor would be required to communicate in the audit report the results of the auditor’s evaluation. Adoption of this proposal would likely increase audit costs.
Disclosures on Auditor’s Relationship with Company

Finally, the PCAOB proposed that the audit report contain a statement regarding the auditor’s existing requirements to be independent from the issuer, and a statement disclosing the year that the audit firm began serving consecutively as the company’s auditor. Opinion differs on whether an auditor’s tenure information is useful to readers of financial statements, although the PCAOB acknowledged that it has not drawn any conclusions about the correlation between auditor tenure and audit quality.

Additional Information

The full text of the PCAOB’s release can be found here.

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CONTACTS

John R. Thomas
Partner
Portland
D +1.503.727.2144

David F. Dedyo
Partner
San Francisco
D +1.415.344.7000

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