

# *Securities Reform Act Litigation Reporter*

A Monthly Reporter Featuring Expert Analysis and Prompt Publication of Oral and Written Decisions

## Editors

William F. Alderman, Esq.  
W. Reece Bader, Esq.

Richard Gallagher, Esq.  
Kenneth Herzinger, Esq.

Amy M. Ross, Esq.  
Michael C. Tu, Esq.

*Orrick, Herrington & Sutcliffe LLP*

---

Volume 36, Number 1

Washington, D.C.

October 2013

---

\* \* \*

## **PCAOB Proposes Significant Changes to Auditor Reports**

David A. Katz & Michael Rosenblat

*Wachtell, Lipton, Rosen & Katz*

Earlier this month, the Public Company Accounting Oversight Board issued a 294 page release proposing two new standards for audit reports which, if adopted, would represent the most significant changes to the form and content of audit reports since the 1940s. *PCAOB Release No. 2013-005.*

The first proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Disclosure Proposal") would require significant additional disclosures by the auditor including with respect to "critical audit matters" identified by the auditor, the auditor's responsibility for, and conclusions with respect to, "Other Information" (*i.e.*, information in an annual report other than the financial statements), enhancements to existing language related to the auditor's responsibilities for fraud and the notes to the financial statements, and disclosure on auditor independence and tenure. The second proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Other Information Proposal") would enhance the auditor's responsibilities for Other Information.

While the new standards would retain the current model of auditor reports where an auditor must opine on whether or not the financial statements of a company present fairly its financial position, they would add a significant layer of additional disclosure relating to key judgments and risks identified by the auditor and would mark a dramatic shift from the long-standing practice of issuers being the sole communicators of key accounting judgments to their shareholders.

The most significant change to the auditor report being proposed relates to the requirement that an auditor disclose matters that it determines to be “Critical Audit Matters.” The Disclosure Proposal 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.” The proposal indicates that critical audit matters ordinarily are matters such as those documented in the engagement completion document (which summarizes the significant issues and findings from the audit), matters reviewed by the engagement quality reviewer or matters communicated to the audit committee.

With respect to each Critical Audit Matter the auditor would be required to identify the matter, describe the considerations that led the auditor to determine that the matter is critical and refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. This required disclosure would fundamentally change the content of an auditor report and could have significant implications on the audit process and the auditor/management/audit committee relationship. Currently, an auditor’s judgments and views are communicated solely to management and the audit committee and the company is responsible for communicating accounting judgments to shareholders through disclosure of its accounting policies in the notes to the financial statements (which is audited) and disclosure of critical accounting estimates and assumptions in the MD&A (which is read by the auditor for consistency with the financial statements). The Disclosure Proposal significantly alters this paradigm by requiring the auditor to communicate directly to shareholders its judgments with respect to these matters. The PCAOB release provides useful examples of hypothetical critical audit matter disclosures as well as an illustrative unqualified auditor’s report.

The Other Information Proposal could also significantly change the audit process by expanding the auditor’s responsibilities for information in an annual report other than the financial statements and auditor report including, among other things, selected financial data, the MD&A, exhibits and certain information incorporated by reference in the annual report. Under the proposal, the auditor would be required to evaluate whether the Other

Information contains a material inconsistency with the financial statements and/or a material misstatement of fact and would be required to perform certain specified procedures in connection with its evaluation based on relevant audit evidence obtained during the audit. The proposed standard is significantly more onerous than the current standard which requires only that the auditor read and consider Other Information for inconsistencies with the financial statements. In addition, while the auditor would not be required to provide an opinion on Other Information, the auditor would have to disclose in the auditor report its responsibilities and the results of its evaluation.

The deadline for comments on the proposals is December 11, 2013 and the PCAOB expects that the proposed standards would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2015. Given the significance of the proposed changes and the potential impact on the cost and scope of the audit process, issuers are encouraged to review the proposals, provide comments and begin to consider how the new rules will affect their financial reporting procedures and their relationship with their auditor.

\* \* \*