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PCAOB SEEKS COMMENTS ON POSSIBLE CHANGES TO REPORTS ON AUDITED FINANCIAL STATEMENTS

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The Public Company Accounting Oversight Board (the “PCAOB”) recently issued a concept release (the “Release”) soliciting public comment on potential changes to the auditor’s reporting model based on the concerns of investors and other financial statement users that the transparency and relevance of the financial statements and the audit process should be enhanced.¹ Although the Release merely seeks comments and does not propose specific changes to the auditor’s report, if final rules in this area are adopted, they could alter the relationship between auditors and public company management and audit committees, including potentially affecting such matters as time and expense spent on the audit, the degree of candor in communications between companies and auditors and exposure to liability due to conflicting auditor and company views.

The Release outlines four PCAOB alternatives for potentially changing the auditor’s reporting model, based on the view that auditors often have significant information about a public company’s financial statements and the audit of the financial statements that is not currently addressed in the auditor’s report but which might be useful to investors and others. Comments on the Release are due September 30, 2011, and the PCAOB also intends to hold a public roundtable event in the third quarter of 2011 to discuss the matters addressed in the Release. The remainder of this client alert outlines these four alternatives.

Background

The standard auditor’s report identifies the financial statements that were audited, describes the nature of the 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 report is commonly described as a “pass/fail model” because the auditor opines on whether the financial statements are fairly presented (a pass) or not (a fail). Although many groups have considered changes to the auditor’s report over the last 50 years, the model has undergone few changes. Recently, the PCAOB staff solicited input from investors, financial statement preparers, auditors, audit committee members, regulators, standard-setters and academics on the content and form of the auditor’s report. During this outreach, some commenters expressed the view that expanded auditor reporting in advance of the recent economic crisis might have been helpful in assessing the quality of companies’ financial statements and providing early warning signals of financial risks.

¹ Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, PCAOB Release No. 2011-003 (June 21, 2011), available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf. See also the Fact Sheet available at http://pcaobus.org/Rules/Rulemaking/Docket034/Fact_Sheet.pdf.

Potential Alternatives for Changes to the Auditor’s Report

The Release presents four alternatives for possible changes to the auditor’s report; each alternative would retain the pass/fail option. According to the PCAOB, the alternatives are not intended to alter the auditor’s ultimate responsibility to obtain sufficient appropriate evidence to support the audit opinion. Likewise, the alternatives are not intended to qualify or piecemeal the auditor’s opinion or shift the requirement to assess the risk of material misstatement of the financial statements from the auditor to investors or other users of financial statements.

The alternatives presented in the Release are not mutually exclusive. A revised auditor’s report could include one or a combination of the alternatives, certain aspects of the alternatives or alternatives not currently presented in the Release. These alternatives would likely require the development of additional auditing standards or rules through collaboration with the Securities and Exchange Commission, including, possibly, additional rules regarding management reporting requirements. Each of the proposed alternatives is discussed below.

Auditor’s Discussion and Analysis

This alternative would require that a new Auditor’s Discussion and Analysis (“AD&A”) be included with an auditor’s report. This supplemental narrative report would be intended to provide the auditor the opportunity to discuss his or her views regarding significant matters, including information about the audit such as audit risk identified in the audit, audit procedures and results and auditor independence. The AD&A could also include a discussion of the auditor’s views regarding the company’s financial statements, such as management’s judgments and estimates, accounting policies and practices and difficult and contentious issues, including “close calls.” The AD&A, as contemplated in the Release, would not be intended to provide separate assurance on individual balances, disclosures, transactions or any other matters discussed; rather, it would be intended to provide investors with a view of the audit and the financial statements “through the auditor’s eyes.”

Because the AD&A would provide the auditor’s perspective about the audit and the company’s financial statements, the views in the AD&A could differ from those management provides in the Management’s Discussion and Analysis (“MD&A”). In addition, the AD&A would likely be among the most expansive form of reporting of the alternatives presented in the Release and could require the auditor to communicate some of the same information in the AD&A that the auditor communicates to the audit committee, thus potentially raising confidentiality concerns.

Required and Expanded Use of Emphasis Paragraphs

The second alternative would require the use of emphasis paragraphs in all audit reports and expand the emphasis paragraphs to highlight the most significant matters in the financial statements and identify where these matters are disclosed in the financial statements. Emphasis paragraphs are not currently required under existing PCAOB standards but may be added at the auditor’s discretion to emphasize a matter regarding the financial statements. Under this proposed alternative, 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. With respect to each matter of emphasis, the auditor could also be required to comment on key audit procedures performed pertaining to the identified matters.

Auditor Assurance on Other Information Outside the Financial Statements

A third alternative would require auditors to provide assurance on information outside the financial statements, such as MD&A or other information (for example, non-GAAP information or earnings releases). The PCAOB suggests in the Release that auditor assurance on information outside the financial statements could improve the reliability of such information, providing investors and other users of financial statements with a higher level of confidence in company information provided by management. Currently, there is no requirement for the auditor to provide assurance on earnings releases, non-GAAP information or MD&A. However, if a company engages an auditor to attest on MD&A, the PCAOB has an attest standard which imposes auditor requirements concerning the performance of the attest engagement. The proposed additional reporting by the auditor on earnings releases, non-GAAP information and all or portions of the MD&A could be based on certain aspects of the current attest standard and report or on other standards.

Clarification of the Standard Auditor's Report

The final alternative discussed in the Release would involve clarifying language in the existing standard auditor's report. While this alternative would not significantly expand the content of the auditor's report, it could provide additional information about what an audit represents and the related auditor responsibilities. Possible language and concepts that could be clarified in the auditor's report include reasonable assurance, the auditor's responsibility for fraud, the auditor's responsibility for financial statement disclosures, management's responsibility for the preparation of the financial statements, the auditor's responsibility for information outside of the financial statements and auditor independence.

Conclusion

We will continue to monitor the PCAOB's efforts in this area. If you have any questions regarding the Release, please contact Meredith P. Burbank (<http://www.wcsr.com/MeredithBurbank>), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/profSearch?team=corporateandsecurities>.

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