

## Heads Up

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The PCAOB's public meeting comprised 10 panel discussions involving participants from various stakeholder groups, including investor advocates, public companies, audit committees, audit firms, academics, and representatives from international standard-setting organizations.

## PCAOB Gathers More Input on Proposed Changes to the Auditor's Report

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The PCAOB hosted a public meeting on April 2 and 3, 2014, to obtain further input on Release 2013-005,<sup>1</sup> which proposes standards to enhance the auditor's reporting model and modify the auditor's responsibilities for other information included in annual reports filed with the SEC (collectively, the "proposed standards"). The meeting comprised 10 panel discussions involving participants from various stakeholder groups,<sup>2</sup> including investor advocates, public companies, audit committees, audit firms, academics, and representatives from international standard-setting organizations. PCAOB Chairman James Doty led the panel discussions, at which the panelists fielded questions from PCAOB members. Representatives from the PCAOB's Office of the Chief Auditor, the SEC, and the FASB, respectively, who attended the discussions as observers, also posed questions for the panelists. In a [news release](#) announcing the meeting, Chairman Doty stated, "We received many thoughtful, reasoned comments on the Board's proposal and this public meeting is intended to further explore the issues." Before the meeting, the Board had received over 200 [comment letter responses](#)<sup>3</sup> to the proposed standards.

For more information about the PCAOB's proposed standards, see Deloitte's September 5, 2013, [Heads Up](#).

### Overview of Panel Discussions

To make the audit process more transparent<sup>4</sup> and the audit report more relevant, the PCAOB has proposed changes to the auditor's reporting model, including the following:

- The addition in the auditor's report of a new section in which critical audit matters (CAMs) specific to an audit would be communicated.
- Enhanced language in the auditor's report about the auditor's responsibilities, and new statements in the report intended to communicate more information about the audit and the auditor.
- An expansion of the auditor's responsibilities for other information in the annual report, and disclosure about this responsibility in the auditor's report, along with a statement about the results of the new required evaluation of that other information.

<sup>1</sup> PCAOB Release No. 2013-005, *Proposed Auditing Standards — The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*.

<sup>2</sup> See the PCAOB's public meeting [agenda](#) for a list of stakeholder participants.

<sup>3</sup> After the public meeting, the comment period was reopened until May 2, 2014.

<sup>4</sup> While not part of the PCAOB's agenda for the public meeting, [PCAOB Release 2013-009](#) on improving the transparency of audits was discussed by panelists at the meeting. For more information about this proposal, see Deloitte's January 6, 2014, [Heads Up](#).

Panelists expressed various views about the proposed requirements, highlighted concerns and potential implementation challenges, and provided additional recommendations. Key themes from the public meeting are outlined below.<sup>5</sup>

### Inclusion of CAMs in the Auditor's Report

Most panelists supported the Board's objectives of increasing the informational value, usefulness, and relevance of the auditor's report. However, a number of them expressed concerns about certain aspects and potential effects of the proposal to include CAMs in the auditor's report. For example, panelists emphasized that the value investors find in the current "pass/fail" reporting model has played an important economic role and should not be overlooked. The most common concerns raised about CAMs were as follows:

- Without further clarification of the proposal, the auditor may be in a position of publicly communicating original information about a company that the company is not necessarily required to disclose (e.g., matters related to going concern, significant deficiencies, or a potential illegal act). On the other hand, if CAM communications merely repeat information provided in management's disclosures, the value provided to investors will be limited. Further, if CAM reporting becomes boilerplate, it may compromise the Board's objective of making the auditor's report more useful to investors.
- Information overload may result from the reporting of too many CAMs or from lengthy descriptions of the audit procedures performed in connection with the CAMs.
- Communication of CAMs may conflict with the governance and oversight role of audit committees and may have the unintended consequence of inhibiting open communication among auditors, management, and audit committees.
- The CAM requirements may create additional time pressure to complete an audit and meet SEC filing deadlines.
- CAM reporting may potentially raise the costs of conducting an audit by increasing auditors' litigation risk and the amount of time required for the audit.

In light of the concerns above, panelists also offered suggestions related to the proposal, including the following:

- Providing clearer guidance on the potential communication of original information about a company. For example, certain matters that companies are not required to disclose (e.g., significant deficiencies in internal control) could be excluded from consideration as a CAM. In addition, the proposal could more explicitly indicate that CAMs would be expected to provide information about the audit that was performed.
- Limiting the auditor's starting population for potential CAMs to matters required to be discussed with the audit committee.
- Requiring CAMs to focus on critical accounting estimates and policies since these are matters of greatest interest to users. In addition, some suggested that an attestation engagement focusing on critical accounting estimates and policies could be an option to consider. Such an attestation engagement could coexist with CAM communications and may also better clarify the auditor's involvement with respect to other information.
- Requiring the auditor to consider materiality and applicability to the financial statements as additional factors when deciding whether potential CAMs are actual CAMs.
- Clarifying whether the description of a CAM in the auditor's report should include a discussion of the procedures related to the CAM. Although the proposal does not expressly require such a discussion, its illustrative examples include a discussion of audit procedures.

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<sup>5</sup> See PCAOB [Docket 034](#) for panelists' public meeting statements.

- Requiring the auditor to tailor CAM descriptions to avoid boilerplate language, and considering options for minimizing litigation risk to further encourage unique and tailored CAM communications.
- PCAOB field testing of the proposal that would allow the Board to better determine the value investors will gain from requiring the auditor to identify and report CAMs.

### Auditor’s Responsibilities Regarding Other Information

Panelists expressed various views on the proposed requirements related to the auditor’s responsibilities regarding other information in annual reports filed with the SEC and emphasized that certain implementation challenges must be considered and addressed before the PCAOB moves forward with the proposal. Their views and recommendations included the following:

- The proposal defines “other information” too broadly. As currently defined, the term would include information in Form 10-K that is not within the scope of the auditor’s expertise and not closely associated with procedures performed during the audit (i.e., nonfinancial data and subjective qualitative statements). The Board should conduct additional investor outreach to get more insight on (1) the value that auditor association with other information will provide and (2) the types of other information with which investors would like the auditor to be associated.
- Investors are increasingly looking at non-GAAP financial measures and are becoming less interested in financial statement data; however, they may be unaware that non-GAAP measures are not being scrutinized by auditors. Accordingly, the proposal should be modified to require auditors to perform procedures on non-GAAP measures.
- Although the proposal is aimed at addressing investors’ desire for better (e.g., subjective) information, it may do the opposite and cause management to report even more other information that is objective and verifiable and less that is subjective.
- Requiring the auditor to “evaluate”<sup>6</sup> other information for any material inconsistency or material misstatement of fact may lead to an expectation gap regarding the auditor’s performance requirements because “evaluate” implies assurance on the entirety of other information. Instead of “evaluate,” the Board should consider using the term “read and consider” since this term is well understood by auditors and investors and most likely would not create an expectation gap regarding the auditor’s level of involvement with other information. Alternatively, the Board should specify the performance necessary to fulfill the requirement to “evaluate.”
- The proposed requirements would most likely result in increased costs for both companies and auditors, which would be passed on to investors.

### Auditor Tenure and Other Basic Elements of the Auditor’s Report

The greater part of this panel discussion was focused on the topic of auditor tenure. While the majority of panelists supported additional transparency regarding information on auditor tenure, most expressed concern that the auditor’s report is not the appropriate place for such disclosure and that alternatives should be considered, such as a registered firm’s annual Form 2, an audit committee’s annual report, or elsewhere in a proxy statement.<sup>7</sup>

Panelists expressed various views on the proposed requirements related to the auditor’s responsibilities regarding other information in annual reports filed with the SEC and emphasized that certain implementation challenges must be considered and addressed before the PCAOB moves forward with the proposal.

<sup>6</sup> The proposed standard would require the auditor to “evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements (“material inconsistency”); (2) a material misstatement of fact; or (3) both and, if so, to respond appropriately” (footnote omitted).

<sup>7</sup> In the United States, the PCAOB does not have oversight authority over audit committees and therefore is unable to change the proxy or other rules governing required audit committee disclosures. At the public meeting, Brian Croteau, deputy chief accountant in the SEC’s Office of the Chief Accountant, encouraged the public to submit comments on this topic for the SEC to consider.

Other panel discussions focused on considerations related to the proposed standards' applicability to investment companies, smaller public companies, and brokers and dealers. For information about those discussions, see the PCAOB's [Web page](#) containing links to meeting transcripts, webcasts, and podcasts.

## International Efforts to Change the Auditor's Reporting Model

In addition to efforts by the PCAOB to improve the auditor's reporting model, several international standard setters and non-U.S. regulators have been working on projects to modify the auditor's report, including the United Kingdom's Financial Reporting Council (FRC), the International Auditing and Assurance Standards Board (IAASB), and the European Commission. The Board invited representatives from the FRC, the IAASB, and the European Union, respectively, to discuss current non-U.S. efforts in this regard. The panels included members of the audit profession and audit committees as well as an investor advocate that have experience with the recent changes outside the United States. Overall, panelists emphasized the importance of globally aligning the various standard-setting and regulatory efforts to consistently enhance users' understanding of both the audit process and the results of the audit and thereby avoid unnecessary confusion.

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### Overview of Recent Changes in the United Kingdom

In June 2013, the FRC adopted revisions to *ISA 700*<sup>8</sup> to enhance transparency of the auditor's report and communication to investors. The changes became effective for auditors reporting on companies that apply the *UK Corporate Governance Code*<sup>9</sup> for periods commencing on or after October 1, 2012. As a result of the revised *ISA 700*, auditors of such companies are now required to do all of the following:

- Describe the risks that had the greatest effect on their overall audit strategy, the allocation of resources in the audit, and the direction the efforts of the engagement team.
- Explain how the concept of materiality was applied in planning and performing the audit.
- Provide an overview of the scope of the audit, showing how the scope addressed the risks described.

In parallel with the changes to *ISA 700*, the FRC made changes to the *UK Corporate Governance Code*, since the FRC also provides oversight of publicly listed companies and sets standards for corporate reporting. As a result of these changes, the annual report is now required to include all of the following:

- Critical accounting judgments formed and key estimates made by management in preparing financial statements.
- The audit committee's report on the significant issues that it considered in relation to the financial statements, and how these issues were addressed.
- The external auditor's report on the risks the external auditor identified that had the greatest effect on the audit and the related audit response (as noted above).

Panelists acknowledged that the audit reporting reforms have been well received by all stakeholders. They applauded the FRC's parallel efforts to reform corporate reporting, which eliminated concerns about disclosing original information about a company. Panelists also noted that the legal environment in the United Kingdom is very different from that in the United States. In addition, one panelist shared his belief that the audit reporting reforms have helped reestablish the value and quality of the audit and have benefited investors by providing more information.

<sup>8</sup> International Standard on Auditing (UK and Ireland) 700, *The Independent Auditor's Report on Financial Statements*.

<sup>9</sup> These rules regulate all companies with a premium listing on the London Stock Exchange, whether they are based in or outside the United Kingdom.

## Other Recent International Efforts

### *IAASB*

In July 2013, the IAASB issued an [exposure draft](#)<sup>10</sup> on changes to the form and content of the auditor's report for audits conducted under IAASB standards. The comment period for this proposal closed on November 22, 2013. For a comparison of the IAASB's and PCAOB's respective proposals related to the auditor's report, see [Appendix A](#) of Deloitte's September 5, 2013, *Heads Up*.

During the public meeting's panel discussion on international developments related to the auditor's report, Arnold Schilder, chairman of the IAASB, noted that the need to consider changes to the auditor's report has been a focus of the IAASB since 2006 and that after the financial crisis, concerns about the value of the audit and heightened demand for more communication from auditors to investors compelled the IAASB to respond. Chairman Schilder acknowledged that collaboration with the PCAOB on changes to the auditor's reporting model has been key to the IAASB's efforts. The IAASB has received strong global support for its exposure draft and is expected to adopt a proposed standard later this year.

### *European Commission*

To improve the quality of statutory audits in the European Union, the European Parliament voted in early April 2014 to approve the European Commission's proposed audit legislation, including modifications to the auditor's report.<sup>11</sup> Such modifications will require statutory auditors in the European Union to include the following:

- The place where the statutory auditor or audit firm is established.
- A statement indicating who was responsible for the appointment of the auditor, the date of the appointment, and the period of total uninterrupted engagement.
- Any material uncertainty related to events or conditions that may raise significant doubt about an entity's ability to continue as a going concern.
- The most significant assessed risks of material misstatements, a summary of the auditor's response to those risks, and, if applicable, key observations about those risks.
- The extent to which the audit was capable of detecting irregularities, including fraud.

The reform will set minimum requirements and allow member states to adopt additional requirements.

At the PCAOB's public meeting, Sven Gentner, counselor in the Economic and Financial Affairs section of the EU delegation to the United States, indicated that the European Union clearly shares the PCAOB's goal of making the auditor's report more informative. The EU legislation will most likely not take effect until 2016.

## Next Steps

The PCAOB has not set a specific timeline for next steps in this proposal process; however, several Board members have indicated that a reproposal, which would include an additional comment period, may be the next step. Release 2013-005 indicates that the proposed standards and amendments would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2015; however, this date depends on the timing of a reproposal (if any) and approval by the PCAOB and SEC of any final standard and related amendments.

IAASB Chairman Arnold Schilder acknowledged that collaboration with the PCAOB on changes to the auditor's reporting model has been key to the IAASB's efforts.

<sup>10</sup> IAASB Exposure Draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*.

<sup>11</sup> For more information, see the European Commission's [Web site](#) on audit reform.

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