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PROPOSED AUDITING STANDARD— THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS	)	PCAOB Release No. 2016-003 May 11, 2016 PCAOB Rulemaking Docket Matter No. 034

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is reproposing a standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which would supersede portions of AS 3101, *Reports on Audited Financial Statements*, and related amendments to PCAOB standards.

Public Comment: Interested persons may submit written comments to the Board. Comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 034 in the subject or reference line and should be received by the Board by August 15, 2016.

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Contents

I. Summary 1

II. Background 6

- A. Rulemaking History 6
- B. Initiatives of Other Regulators and Standard Setters 8

III. Overview of the Reproposal 12

IV. Discussion of the Reproposal 16

- A. Auditor Communication of Critical Audit Matters 16
- B. Additional Improvements to the Auditor's Report 42
- C. Explanatory Language and Emphasis of a Matter 53
- D. Information About Certain Audit Participants 57
- E. Form of the Auditor's Report 58

V. Amendments to Other PCAOB Standards 59

- A. Proposed AS 3105 59
- B. Other Amendments to PCAOB Standards 61

VI. Economic Considerations 62

- A. Need for the Rulemaking 62
- B. Baseline 68
- C. Benefits 70
- D. Costs and Potential Unintended Consequences 81
- E. Alternatives Considered, Including Policy Choices Under the Reproposal 91

VII. Exclusions from Critical Audit Matter Requirements 98

- A. Brokers and Dealers 98
- B. Investment Companies 100
- C. Benefit Plans 103

VIII. Considerations for Audits of Emerging Growth Companies 106

IX. Considerations Related to Effective Date 109

X. Opportunity for Public Comment 110

Appendix 1: Proposed AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* A1-1

Appendix 2: Amendments to Other PCAOB Standards Related to the Proposed Standard A2-1

Appendix 3: Characteristics of Self-Identified EGCs A3-1

I. Summary

The Board is reproposing the auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("reproposed standard" or "reproposal"). The reproposal would retain the pass/fail model of the existing auditor's report, which is generally acknowledged to be a useful signal as to whether the audited financial statements are presented fairly. Consistent with the Board's statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports,"[1] the reproposal also seeks to enhance the form and content of the report to make it more relevant and informative to investors and other financial statement users. In particular, the auditor's report would include a description of "critical audit matters," which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit as they relate to the relevant financial statement accounts and disclosures.

The reproposal builds on more than five years of Board outreach, in which many investors and other financial statement users have consistently urged the Board to make the auditor's report more relevant and informative. Outside the United States, other regulators and standard setters have also moved toward expanded auditor reporting.

The auditor's report is the primary means by which the auditor communicates information regarding the audit of the financial statements to investors and other financial statement users. As currently designed, however, the auditor's report conveys very little of the information obtained and evaluated by the auditor as part of the audit. And while the auditor's report has generally remained unchanged since the 1940s, companies' operations have become more complex and global, and the financial reporting frameworks have evolved toward an increasing use of estimates and fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, this information is not known to investors. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the current form of the auditor's report does little to address the information asymmetry[2] between investors and auditors. This may

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[1] Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

[2] Economists often describe this imbalance, where one party has more or better information than another party, as "information asymmetry." As part of the system of financial reporting, the audit of the financial statements helps reduce the information

limit the extent to which the auditor's report can address the information asymmetry between investors and management.

In recent years, many investors and others have stated that auditors should provide additional information in the auditor's report to make the report more relevant and useful.[3] At the same time, other commenters, primarily issuers and accounting firms, have argued that it would be inappropriate for the auditor to provide financial analysis or disclosures on behalf of the company being audited. The reproposed standard is intended to respond to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report, without imposing requirements beyond the auditor's expertise or mandate.

The communication of critical audit matters would inform investors and other financial statement users of matters arising from the audit that required especially challenging, subjective, or complex auditor judgment, and how the auditor responded to those matters. The Board believes that critical audit matters are likely to be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; unusual transactions; and other significant changes in the financial statements.

In addition to informing investors and other financial statement users about areas of the audit that were especially challenging, subjective, or complex and helping them understand how the auditor addressed these areas, the Board believes that the communication of critical audit matters should help focus investor attention on these matters and provide a new perspective on the financial statements. For instance, additional reporting by the auditor could facilitate analysis of the financial statements and help investors and analysts engage management with targeted questions about

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asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

[3] *See* survey, *Improving the Auditor's Report*, which was presented by the working group of the PCAOB's Investor Advisory Group ("IAG") on the Auditor's Report and The Role of the Auditor (Mar. 16, 2011) ("IAG 2011 survey"). *See also* CFA Institute's *Usefulness of the Independent Auditor's Report Survey Results* (May 4, 2011); *Independent Auditor's Report Survey Results* (Mar. 31, 2010); and *Independent Auditor's Report Monthly Poll Results* (Mar. 12, 2008) ("CFA survey and poll results"). *See also* transcripts and participant statements from the Board's April 2014 public meeting, available on the Board's website in Rulemaking Docket Matter No. 034, *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments* ("Docket 034").

critical audit matters. To the extent the identification and communication of critical audit matters increases focus by auditors, audit committees, and management on the matters identified as critical audit matters, it may also lead to an incremental increase in audit quality and the quality of information presented in the financial statements and related disclosures.

In addition to critical audit matters, the reproposal includes other improvements to the existing auditor's report under AS 3101 (currently AU sec. 508[4]), *Reports on Audited Financial Statements*, primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements and make the auditor's report easier to read.

The reproposed standard would include the following significant changes to the existing auditor's report:

- *Critical audit matters*—would require communication in the auditor's report of any critical audit matters arising from the audit of the current period's financial statements.
  - o *Definition of a critical audit matter*—any matter that was communicated or required to be communicated to the audit committee and that:
    - ▪ Relates to accounts or disclosures that are material to the financial statements, and
    - ▪ Involved especially challenging, subjective, or complex auditor judgment.
  - o *Factors in determining critical audit matters*—the auditor would take into account a nonexclusive list of factors in determining whether a matter

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[4] In 2015, the PCAOB adopted and the U.S. Securities and Exchange Commission ("SEC") approved the reorganization of PCAOB auditing standards using a topical structure and a single, integrated numbering system. *See Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015); SEC, *Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules To Implement the Reorganization of PCAOB Auditing Standards and Related Changes to PCAOB Rules and Attestation, Quality Control, and Ethics and Independence Standards*, Exchange Act Release No. 75935 (Sept. 17, 2015), 80 FR 57263 (Sept. 22, 2015). The reorganized amendments will be effective as of December 31, 2016, but may be used and referenced before that date. *See* PCAOB Release No. 2015-002, at 21.

involved especially challenging, subjective, or complex auditor judgment, such as the auditor's assessment of the risks of material misstatement, including significant risks.

- o *Communication in the auditor's report*—the auditor would identify the critical audit matter, describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, describe how it was addressed in the audit, and refer to the relevant financial statement accounts and disclosures. If there are no critical audit matters, the auditor would so state in the auditor's report.
- o *Documentation*—the auditor would document the basis for its determination of whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved especially challenging, subjective, or complex auditor judgment.

- *Additional Improvements to the Auditor's Report*
  - o *Clarifications of existing auditor responsibilities*—enhance certain standardized language in the auditor's report, including adding a statement about auditor independence and the phrase "whether due to error or fraud," when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements;
  - o *Tenure*—add a basic element of the auditor's report related to auditor tenure; and
  - o *Standardized form of the auditor's report*—require the opinion be the first section of the auditor's report and require section titles to guide the reader.

The reproposal has been informed by comments received on the 2013 proposal,[5] the Board's April 2014 public meeting,[6] analysis of economic considerations, academic research, and international developments. In particular, while the concept of critical

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[5] *See 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*, PCAOB Release No. 2013-005 (Aug. 13, 2013) ("2013 proposal" or "proposed standard").

[6] *See* transcripts and participant statements from the public meeting, available on the Board's website in Docket 034.

audit matters has been carried forward from the 2013 proposal, the reproposed requirements have been narrowed in a number of respects, including by:

- Limiting the source of potential critical audit matters to matters communicated or required to be communicated to the audit committee;

- Adding a materiality component to the definition of critical audit matter;

- Narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment; and

- Revising the related documentation requirement.

In addition, the reproposed communication requirement has been expanded to require the auditor to describe how the critical audit matter was addressed in the audit. As under the 2013 proposal, the reproposed communication of critical audit matters would not change the auditor's current role of attesting to information prepared by management.

The reproposed standard would generally apply to audits conducted under PCAOB standards. However, unlike the 2013 proposal, communication of critical audit matters would not be required for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5; investment companies other than business development companies; and employee stock purchase, savings, and similar plans ("benefit plans").[7]

The 2013 proposal also included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements.[8] The Board is not reproposing the "other information" auditing standard at this time but plans to determine next steps at a later date.

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[7] The other requirements of the reproposed standard would be applicable to audits of these types of entities.

[8] *See* PCAOB Release No. 2013-005.

II. Background

A. Rulemaking History

Changes to the auditor's report have been discussed by several commissions and committees, including the 2008 U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP").[9] ACAP recommended that the PCAOB consider improvements to the auditor's report, noting that the increasing complexity of global business operations compels a growing use of judgments and estimates, including those related to fair value measurements, and also contributes to greater complexity in financial reporting.

The PCAOB commenced its standard-setting project on the auditor's reporting model in 2010 with outreach to different stakeholders, including investors, financial statement preparers, and auditors. During that outreach, many investors expressed dissatisfaction with the content of the existing auditor's report because it provides to investors little, if any, information specific to the audit of the company's financial statements. Generally, preparers, audit committee members, and auditors were not supportive of adding company-specific information to the auditor's report, arguing that the company, through its management or audit committee, should be the primary source of the company's financial information. Changes to the auditor's report were also discussed at the March 2011 IAG meeting.[10] Some investors who participated in that meeting suggested that expanded auditor reporting would have been helpful before and during the 2008 financial crisis.[11] Later in March 2011, the Board held an open meeting to discuss findings from its outreach.[12]

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[9] *See* ACAP, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (Oct. 6, 2008), at VII:17. *See also* The 103rd American Assembly, *The Future of the Accounting Profession* (Nov. 2003); *Report of the National Commission on Fraudulent Financial Reporting* (Oct. 1987); and American Institute of Certified Public Accountants, *Commission on Auditor's Responsibilities: Report, Conclusions, and Recommendations* (1978).

[10] *See* IAG meeting details and webcast for March 2011, available on the Board's website.

[11] *See* presentation by the working group of the IAG on *Lessons Learned from the Financial Crisis* (Mar. 16, 2011).

[12] *See* meeting details and webcast for PCAOB Open Board meeting on March 22, 2011, available on the Board's website.

In June 2011, the Board issued a concept release to solicit comment on a number of potential changes to the auditor's report.[13] The Board also held a public roundtable in September 2011 to obtain additional insight on the alternatives presented in the concept release.[14] Changes to the auditor's report were also discussed at the November 2011 and 2012 meetings of the Board's Standing Advisory Group ("SAG").[15]

After considering the results of its outreach and comments on its concept release, in August 2013, the Board proposed an auditing standard that included, among other things, new requirements for auditors to communicate critical audit matters, as well as additional improvements to the auditor's report.[16] The Board received 248 comment letters on the 2013 proposal. Most commenters to the 2013 proposal generally supported the Board's objective to improve the auditor's report to make it more informative and relevant to financial statement users, but commenters' views varied on the nature and extent of such changes, particularly as to critical audit matters.[17] Commenters generally supported changes to the basic elements; however, commenters' views varied as to critical audit matters, with investors and large accounting firms generally supporting communication of critical audit matters, with some modifications, smaller accounting firms being less supportive, and preparers and audit committee members generally opposing communication of critical audit matters.

In April 2014, the Board held a public meeting to obtain further input on the 2013 proposal from a diverse group of investors and other financial statement users, preparers, audit committee members, auditors, and others.[18] The 2013 proposal was

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[13] *See Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards; Notice of Roundtable*, PCAOB Release No. 2011-003 (June 21, 2011) ("concept release").

[14] *See* transcript of the roundtable, available on the Board's website in Docket 034.

[15] *See* SAG meeting transcripts, available on the Board's website in Docket 034.

[16] *See* PCAOB Release No. 2013-005.

[17] *See* comment letters on the 2013 proposal, available on the Board's website in Docket 034.

[18] *See* transcripts and participant statements from the public meeting, available on the Board's website in Docket 034.

further discussed at the November 2013 and June 2014 SAG meetings, and the October 2013 and October 2014 IAG meetings.[19]

B. Initiatives of Other Regulators and Standard Setters

1. Overview of the Requirements of the IAASB, the EU, and the FRC

The form and content of the auditor's report is undergoing change globally. In recent years, several international regulators and standard setters, including the International Auditing and Assurance Standards Board ("IAASB"), the European Union ("EU"), and the Financial Reporting Council in the United Kingdom ("FRC"), have adopted requirements for expanded auditor reporting that go beyond the binary pass/fail model. While their underlying requirements for expanded auditor reporting differ in the details, there is a common theme in these initiatives: communicating information about audit-specific matters in the auditor's report. In addition to expanded auditor reporting, many of these initiatives also include other changes to the form and content of the auditor's report.

Several commenters have urged the Board to work together with these other regulators and standard setters to improve the auditor's report. The Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Even so, the Board is considering carefully the efforts undertaken in other jurisdictions, and, as described in more detail below, the Board's reproposal is analogous in many respects to auditor reporting requirements recently established in other jurisdictions.

IAASB. In September 2014, the IAASB adopted changes to the requirements for the auditor's report, including a new requirement for the auditor to communicate "key audit matters" for audits of listed companies.[20] Key audit matters are selected from matters communicated with those charged with governance and are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.[21] The IAASB requires that the description of each key audit matter in the auditor's report include: (1) why the matter

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[19] *See* SAG and IAG meeting transcripts, available on the Board's website in Docket 034.

[20] The IAASB changes to the auditor's report are effective for audits of financial statements for periods ending on or after December 15, 2016.

[21] *See* paragraph 8 of International Standard on Auditing ("ISA") 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

was considered to be a key audit matter, (2) how the matter was addressed in the audit, and (3) reference to the related disclosures, if any, in the financial statements.[22]

As part of its auditor reporting project, the IAASB also adopted additional changes to the form and content of the auditor's report. These include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit,[23] an enhanced description of the responsibilities of the auditor,[24] and requiring the auditor's opinion to be the first paragraph of the auditor's report.[25]

EU. In April 2014, the EU adopted legislation creating a number of new requirements, including expanded auditor reporting requirements, for audits of public-interest entities ("PIEs"), such as listed companies, credit institutions, and insurance companies.[26] Under the EU reforms, the auditor's report for a PIE is required to include a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, as well as a summary of the auditor's response to those risks and, where relevant, key observations arising with respect to those risks. In addition, the EU reforms require a statement that the auditor remained independent of the audited entity and disclosure of auditor tenure.

FRC. In June 2013, the FRC revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code.[27] The auditors of those entities

[22] *See* paragraph 13 of ISA 701.

[23] *See* paragraph 28(c) of ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*.

[24] *See* paragraph 37 of ISA 700.

[25] *See* paragraph 23 of ISA 700.

[26] *See* Article 10, *Audit Report*, of Regulation (EU) No 537/2014 of the European Parliament and of the Council ("Regulation (EU) No 537/2014"). EU member states have until June 2016 to adopt the provisions of the EU legislation into their own national laws and rules. Information on member state implementation is available at http://ec.europa.eu/finance/auditing/reform/index_en.htm.

[27] These entities include companies with a premium listing of equity shares on the London Stock Exchange, regardless of whether they are incorporated in the U.K. or elsewhere. The changes made to the auditor's report were designed to complement other changes made to the UK Corporate Governance Code that require the audit

are required, among other things, to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of resources in the audit; and (3) directing the efforts of the engagement team. In addition, auditors are required to provide an explanation of how the scope of the audit addressed the risks.[28]

In April 2016, the FRC adopted a final rule updating its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements.[29] Under the final rule, the FRC adopted the IAASB's definition of key audit matters. In the application and other explanatory material on the definition of key audit matters, the FRC identified risks of material misstatement, as determined under both its existing requirements and those of the EU, as key audit matters under that definition. When the FRC proposed these rule changes in September 2015, it stated that it did not expect the incorporation of its own requirements and those of the EU to result in an increase in the number of key audit matters communicated in the auditor's report over what would be required by the IAASB standard alone.[30]

2. Comparison of the Board's Reproposal to Other Requirements

Even though the underlying auditor reporting requirements of other regulators and standard setters are different in the details, in many respects, the initiatives are analogous to the Board's reproposal. All of these initiatives would result in expanding the auditor's report beyond the traditional pass/fail model to communicate information specific to the particular audit. Although the processes of identifying these matters would vary across jurisdictions, there are commonalities in the underlying criteria

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committee to describe significant issues it considered relating to the financial statements. *See* Section C.3.8 of FRC UK Corporate Governance Code (Sept. 2012).

[28] *See* paragraphs 19A–B of ISA (UK and Ireland) 700 (Revised June 2013), *The Independent Auditor's Report on Financial Statements* ("UK ISA 700 (2013)"). The FRC 2013 requirements became effective for audits of financial statements for periods beginning on or after October 1, 2012.

[29] *See* the FRC's Final Draft, International Standards on Auditing (UK and Ireland) 701*, Communicating Key Audit Matters in the Independent Auditor's Report* (Apr. 2016). This rule is effective for audits of financial statements for periods beginning on or after June 17, 2016.

[30] *See* the FRC's *Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees* (Sept. 2015).

regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches. The Board will continue monitoring developments of expanded auditor reporting in other jurisdictions throughout the rulemaking process and will continue to consider their relevance to its own standard-setting project.[31]

Section IV, *Discussion of the Reproposal*, includes descriptions of IAASB, EU, and FRC 2013 requirements that are analogous to the key provisions of the reproposed standard. The FRC recently adopted a final rule that updates its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, which has not yet gone into effect. Because the FRC 2013 requirements govern the expanded auditor reporting that has occurred in the United Kingdom and is the subject of the FRC reports and academic studies described elsewhere in this release, the FRC 2013 requirements are used as a basis for comparison.

The IAASB's standard is most similar to the Board's reproposal since it requires the auditor to communicate key audit matters selected from matters communicated with those charged with governance. The FRC, under its 2013 requirements, and the EU start with the risks of material misstatement and contemplate a different process for determining matters to be communicated than the Board's reproposal. The FRC stated, however, that key audit matters under the IAASB standard are broadly equivalent to the assessed risks of material misstatement included in the UK ISA 700 (2013).[32]

The IAASB and the FRC 2013 requirements are also accompanied by application and other explanatory materials that provide further guidance on the standards. These materials are excluded from the descriptions that follow of the IAASB, EU, and FRC provisions because they are not part of the requirements.

[31] For example, the Board and PCAOB staff had discussions with representatives from the IAASB, EU, and FRC regarding their initiatives, and the April 2014 public meeting included representatives from these organizations.

[32] *See* the FRC's *Extended Auditor's Reports, A Further Review of Experience* (Jan. 2016) ("FRC 2016 Report"), at 7.

III. Overview of the Reproposal

The Board is reproposing the auditor reporting standard, which would retain the pass/fail opinion[33] of the existing auditor's report but would make significant changes to the existing auditor's report, including the following:

- *Critical audit matters*—would require the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit or state that the auditor determined that there are no critical audit matters (*see* Figure 1):
  - A critical audit matter would be defined as a matter that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.
  - In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor would take into account, alone or in combination, factors specific to the audit, including:
    - The auditor's assessment of the risks of material misstatement, including significant risks;
    - The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
    - The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;
    - The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

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[33] This type of opinion has been commonly described as pass/fail because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail).

        - The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

        - The nature of audit evidence obtained regarding the matter.

    - The communication of each critical audit matter would include:

        - Identifying the critical audit matter;

        - Describing the principal considerations that led the auditor to determine that the matter is a critical audit matter;

        - Describing how it was addressed in the audit; and

        - Referring to the relevant financial statement accounts and disclosures.

    - The documentation of critical audit matters would include the basis for the auditor's determination of whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved especially challenging, subjective, or complex auditor judgment.

- *Additional Improvements to the Auditor's Report* – the reproposal also includes a number of other improvements to the auditor's report that are primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements, provide additional information about the auditor, or make the auditor's report easier to read:

    - *Independence*—include a statement regarding the requirement for the auditor to be independent;

    - *Auditor tenure*—include a statement regarding the auditor's tenure;

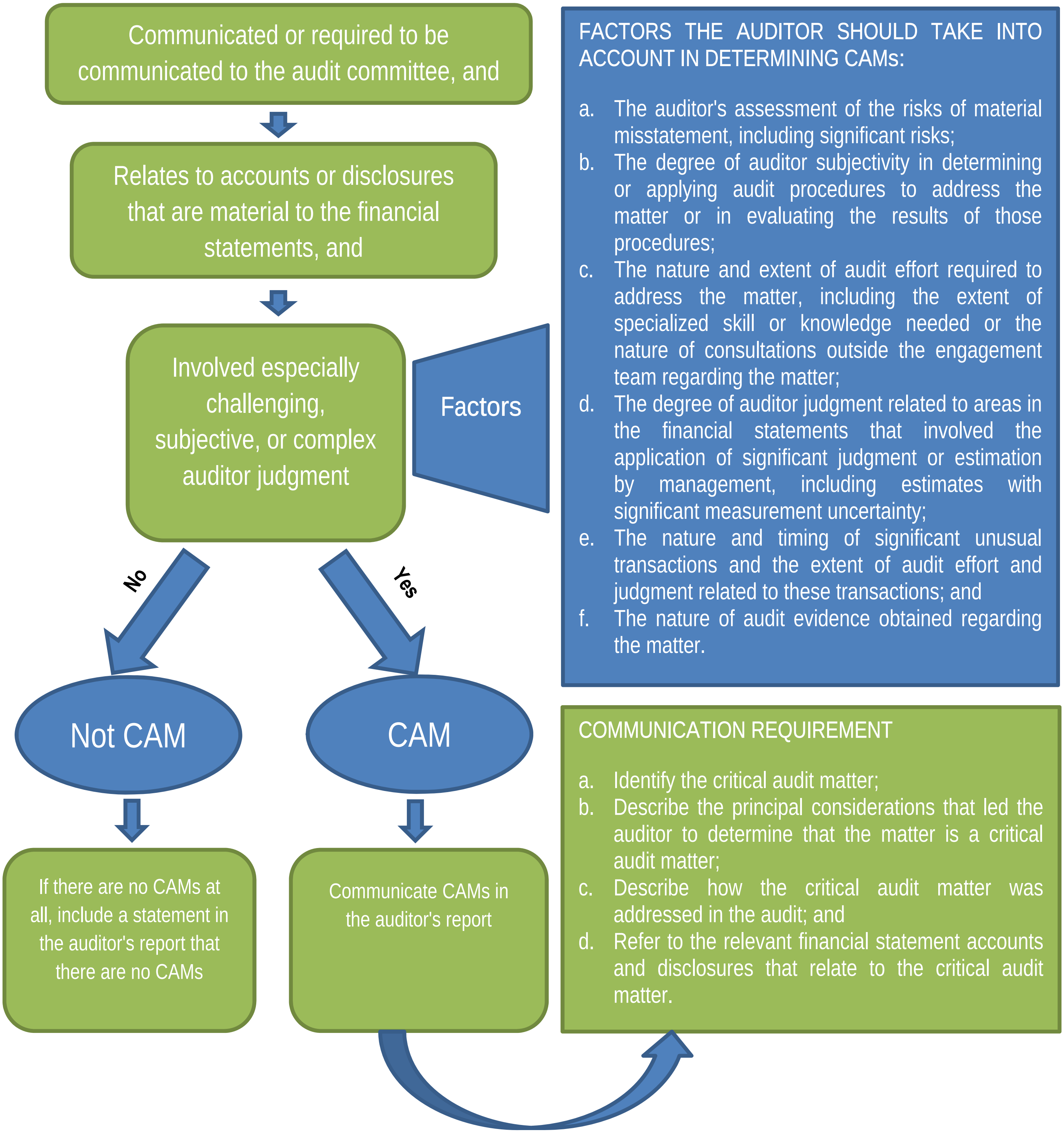
    - *Addressee*—include a requirement to address the auditor's report to the company's shareholders and board of directors or equivalents, and expressly permit additional addresses;

    - *Enhancements to basic elements*—enhance certain standardized language in the auditor's report, including adding the phrase *whether due to error or fraud*, when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements; and

- o *Standardized form of the auditor's report*—require the opinion to be the first section of the auditor's report and require section titles to guide the reader.

The reproposed standard is attached as Appendix 1.

***Figure 1*. Determining and Communicating Critical Audit Matters ("CAMs")**



IV. Discussion of the Reproposal

A. Critical Audit Matters

The 2013 proposal introduced the concept of "critical audit matters," which the auditor would have been required to communicate in the auditor's report. Communication of critical audit matters in the auditor's report was intended to provide more information about the audit and therefore make the auditor's report more informative and relevant to investors and other financial statement users.

Investors, investor advocates, and analysts generally supported the proposed requirement to communicate critical audit matters. Some of them stated that the communication of critical audit matters would be relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor and focusing their attention on issues that would be pertinent to understanding the financial statements. The larger accounting firms generally supported including critical audit matters in the auditor's report, with some modification of the proposed requirements, while smaller accounting firms and associations of accountants were generally less supportive and suggested that critical audit matter reporting may be misunderstood by investors and other financial statement users. Some commenters, primarily companies and audit committee members, did not support the requirements. These commenters asserted that critical audit matters would not provide relevant information to investors, may be duplicative of the company's disclosure, may result in disclosing information not otherwise required to be disclosed, could increase cost, or could delay completion of the audit. The Board has taken into consideration all comments, including those received from investors, accounting firms, companies, audit committee members, and others in reproposing auditor communication of critical audit matters.

Under the reproposal, the concept of critical audit matters is similar to the one introduced in the 2013 proposal.[34] However, the definition of critical audit matter and other requirements have been modified based on comments and other considerations. Critical audit matters would be determined using a principles-based framework leveraging the work already performed by the auditor under existing PCAOB standards. Since critical audit matters are determined using a principles-based framework, the Board anticipates that the critical audit matters would be scalable based on the size, nature, and complexity of the audit.

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[34] Communication of critical audit matters would not be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5; investment companies other than business development companies; and benefit plans. *See* Section VII.

1. Determination of Critical Audit Matters

a. Definition of Critical Audit Matter

The definition of critical audit matters in the 2013 proposal included 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 the opinion on the financial statements.

Under the 2013 proposal, critical audit matters ordinarily would have been included in matters required to be: (1) documented in the engagement completion document, which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three.

In the reproposal, the standard has been revised to define a critical audit matter as any matter arising from the audit[35] of the financial statements that was *communicated or required to be communicated to the audit committee* and that *relates to accounts or disclosures that are material to the financial statements* and *involved especially challenging, subjective, or complex auditor judgment*.

i. Communicated or Required to Be Communicated to the Audit Committee

Commenters generally suggested that the matters communicated to the audit committee should be the source for the auditor's determination of critical audit matters. A commenter stated that, given the audit committee's oversight of the audit and role in representing the interests of shareholders, this would be an appropriate starting point for consideration of critical audit matters. In a limited implementation trial by several accounting firms of auditor reporting requirements under the 2013 proposal, engagement teams observed that using matters communicated to the audit committee

[35] Rather than referring to "matters addressed during the audit," the reproposed definition refers to matters "arising from the audit." This aligns with the terminology used in AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees,* regarding matters required to be communicated to the audit committee.

as the only source for identification of critical audit matters "might be more effective and may result in the identification of those matters important to the audit in a more effective and efficient manner."[36]

Some commenters stated that matters documented in the engagement completion document and reviewed by the engagement quality reviewer would have already been considered when determining which matters to communicate to the audit committee. Some of these commenters also asserted that it is unlikely that a matter that is determined to be a critical audit matter would not have already been communicated to the audit committee. Other commenters noted that limiting the source of critical audit matters to matters communicated to the audit committee would limit the possibility of considering and communicating too many matters as critical audit matters.

In response to comments, the reproposed standard narrows the source of critical audit matters to matters communicated or required to be communicated to the audit committee. This approach would build on auditor communication requirements under AS 1301, other PCAOB rules and standards,[37] and applicable law,[38] and would also include communications made to the audit committee that were not required as a source of potential critical audit matters.

PCAOB standards require the auditor to communicate to the audit committee, among other things:

- Significant risks identified by the auditor;
- Certain matters regarding the company's accounting policies, practices, and estimates;

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[36] This limited implementation trial (described by the Center for Audit Quality as a "field test") was initiated and conducted by nine registered public accounting firms under the auspices of the Center for Audit Quality. *See* letter from the Center for Audit Quality (June 19, 2014), at 4, available on the Board's website in Docket 034.

[37] *See* Appendix B of AS 1301, which identifies other rules and standards that require audit committee communication, such as AS 2410 (currently Auditing Standard No.18), *Related Parties*, and AS 2502 (currently AU sec. 328), *Auditing Fair Value Measurements and Disclosures*.

[38] *See, e.g.*, Section 10A(k) of the Exchange Act, 15 U.S.C. 78j-1(k); Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Exchange Act, 17 CFR 240.10A-3.

- Significant unusual transactions;

- Certain matters regarding the auditor's evaluation of the company's relationships and transactions with related parties; and

- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Required communications to the audit committee generally include the areas in which investors have expressed particular interest in obtaining information in the auditor's report.

Under the reproposal, critical audit matters would be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). It seems likely that especially challenging, subjective, or complex auditor judgments would relate to areas that are required to be communicated to the audit committee, either under a specific requirement or more broadly as a matter that is significant to audit committee oversight of the financial reporting process.[39] The approach under the reproposal scopes in the broadest population of audit committee communications and would not require the auditor to determine whether matters communicated to the audit committee were required to be communicated.

Some commenters expressed concerns that requiring communication of critical audit matters could have a chilling effect on auditor communications with the audit committee. With respect to any matters required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. It would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee. Given the broad scope of communications required under AS 1301, there should be few communications affected by that possibility. Moreover, other factors, including the two-way dialogue between the audit committee and the auditor, should mitigate the risk of reduced communications.

ii. Relates to Accounts or Disclosures That Are Material to the Financial Statements

Some commenters suggested limiting critical audit matters to matters that are material to the financial statements. These commenters were concerned that the auditor otherwise may be required to communicate information that management is not required to disclose under the applicable financial reporting framework and SEC

[39] *See* AS 1301.24.

reporting requirements. Some commenters also stated that communicating immaterial matters would: (1) lead management to revise its disclosures to include a discussion of any matter identified as a critical audit matter, regardless of materiality or (2) weaken and obscure the auditor's opinion because such matters would be irrelevant to investors and other financial statement users.

In response to comments, the reproposed definition of critical audit matters requires that the matter relate to accounts or disclosures that are material to the financial statements.[40] "Relates to" clarifies that the critical audit matter could be an element of an account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. For example, the auditor's evaluation of the company's goodwill impairment assessment could be a critical audit matter; it would relate to goodwill because impairment is an element of that account. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements or relate to many accounts or disclosures. For example, the auditor's evaluation of the company's ability to continue as a going concern or the risk of management's override of internal control could also represent critical audit matters depending on the circumstances of a particular audit.

Because the definition of critical audit matters has been narrowed to include only those matters that relate to accounts or disclosures that are material to the financial statements, there may be certain matters that would have been critical audit matters under the 2013 proposal that would not be critical audit matters under the reproposed standard. For example, a loss contingency that was communicated to the audit committee, but that was determined to be remote and thus not to warrant disclosure under the applicable financial reporting framework, would not meet the reproposed definition of a critical audit matter even if it involved especially challenging auditor judgment. However, matters that would not themselves constitute critical audit matters under the reproposed definition, such as information about the company’s processes and controls, could be included, for example, in the description of the principal considerations that led the auditor to determine that a matter is a critical audit matter.

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[40] The definition of materiality is established under the U.S. federal securities laws. In interpreting those laws, the U.S. Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *See also Basic, Inc. v. Levinson*, 485 U.S. 224, 231 to 232 (1988). As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ." *TSC Industries*, 426 U.S. at 450.

iii. Involved Especially Challenging, Subjective, or Complex Auditor Judgment

While some commenters generally supported the proposed definition of critical audit matters, other commenters were concerned that including the second and third criteria of the proposed definition (matters that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence or in forming the opinion on the financial statements) could lead to the reporting of unimportant matters or to misinterpretation by users of the financial statements that the auditor is uncomfortable with the related accounting or disclosure of the matter identified as a critical audit matter.

In response to comments, the reproposed standard retains only the first criterion of the proposed definition, but revises it from "involved the most difficult, subjective, or complex auditor judgments" to "involved especially challenging, subjective, or complex auditor judgment." The proposal included a note clarifying that the word "most" did not imply that only one matter would qualify as a critical audit matter. The use of the word "especially" in the reproposal is intended to convey more clearly that there could be multiple critical audit matters and that the matters are assessed on a relative basis within the specific audit. Further, the word "difficult" was replaced with "challenging" in the reproposed definition based on a commenter's suggestion that "difficult" has negative overtones that suggest critical audit matters are necessarily problematic.

Several commenters suggested that investors would be most interested in auditor reporting on: (1) significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them; (2) areas of high financial statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.[41]

The reproposed critical audit matter definition would likely cover issues raised in auditing many of the areas identified by investors. For example, the auditor may communicate critical audit matters related to significant management estimates and judgments, areas of the financial statements with a higher risk of material misstatement and audit risk, and significant unusual transactions. However, communication of auditor's assessments of the quality of a company's accounting practices and policies, while not precluded, is not required under the reproposal because there is no framework for such assessments and the determinations are inherently subjective.

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41 These are the same categories of information identified by investor respondents to the IAG 2011 survey.

b. Factors

The 2013 proposal included the following nonexclusive list of factors for the auditor to take into account when determining whether a matter involved the most difficult, subjective, or complex auditor judgment:

- The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
- The nature and extent of audit effort required to address the matter;
- The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;
- The severity of control deficiencies identified relevant to the matter, if any;
- The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;
- The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;
- The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and
- The nature of consultations outside the engagement team regarding the matter, if any.

Commenters in general stated that including factors to consider would assist the auditor in determining critical audit matters.

In the limited implementation trial conducted by several accounting firms, engagement teams observed that the factors that appeared to be most useful in determining critical audit matters were those relating to the degree of auditor subjectivity in determining or applying audit procedures, the nature and extent of audit effort required to address the matter, and the nature and amount of available audit evidence.[42] Under the reproposed standard, these three factors would be retained substantially as proposed. The limited implementation trial also suggested that factors related to the extent of specialized skill or knowledge needed to apply audit procedures and the nature of consultations were also relevant to the determination of critical audit matters. Under the reproposed standard, these factors were retained but combined to create one factor on the nature and extent of audit effort.

Some commenters questioned the usefulness of two factors included in the 2013 proposal: the severity of relevant control deficiencies and the nature and significance of corrected and uncorrected misstatements. Some of these commenters stated that these factors would lead the auditor to determine matters as critical audit matters in areas where the company has no existing reporting obligation, such as control deficiencies less severe than material weaknesses, or where the company has determined that the matters are not material and therefore do not require disclosure under the financial reporting framework, such as uncorrected misstatements that were deemed immaterial. In response to comments and to align the factors with the revised definition of critical audit matters, the reproposed standard does not retain these as separate factors. However, aspects of these factors could still be relevant in the auditor's consideration of other factors, such as the nature and extent of audit effort required to address the matter.

Additionally, the Board modified the factor related to the auditor's assessment of risks of material misstatement, which under the 2013 proposal had focused on changes from the auditor's initial risk assessment. A commenter stated that the proposed factor was less relevant than other proposed factors in determining critical audit matters. Some commenters stated that determination of critical audit matters should focus on audit risk or significant risk. Recognizing the importance of the auditor's entire risk assessment process and in response to comments, the reproposed factor encompasses more broadly the auditor's assessment of risks of material misstatement, including significant risks, rather than just changes in the auditor's risk assessment.

The Board also modified the factor related to the auditor obtaining available relevant and reliable evidence. A commenter stated that matters for which the auditor had the most difficulty in obtaining relevant and reliable audit evidence may not be relevant to users of the financial statements. However, as noted above, in the limited implementation trial conducted by several accounting firms, engagement teams observed that this factor appeared to be one of the most useful in determining critical audit matters.[43] After considering comments, the proposed factor was retained but

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[42] *See* letter from the Center for Audit Quality (June 19, 2014), at 4, available on the Board's website in Docket 034.

[43] *Id*.

aligned with the reproposed definition of critical audit matters, which no longer includes matters that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, and focused on the nature of audit evidence obtained regarding the matter.

Some commenters suggested new areas that could be of particular interest to investors and useful in the determination of critical audit matters. In addition, a commenter on the PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014), suggested that significant measurement uncertainty be added as a consideration in determining critical audit matters. In response to these comments, the reproposed standard includes the following new factors:

- *The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty*—Areas of the financial statements in which management has to apply significant judgment and estimation are likely to include highly uncertain matters or matters that are susceptible to significant measurement uncertainty.

- *The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions*—A company's significant unusual transactions can create complex accounting and financial statement disclosures and could pose increased risks of material misstatement.

Some commenters also recommended a factor based on the extent of interaction with the audit committee. The reproposed standard does not include this factor because the extent of interaction might not be a meaningful indicator of the complexity or significance of the matter and it may create incentives to limit communication between the auditor and the audit committee.

Under the reproposed standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts or disclosures that are material to the company's financial statements, the auditor would take into account the following nonexclusive list of factors when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

- The auditor's assessment of the risks of material misstatement, including significant risks;

- The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;

- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

- The nature of audit evidence obtained regarding the matter.

The determination should be made in the context of the particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks. The reproposed factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective, or complex auditor judgment. Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on only one factor, a combination of the factors, or other factors specific to the audit.

Because the determination of critical audit matters is principles-based, the standard does not contemplate circumstances or matters that, if present, would always constitute critical audit matters. For example, the standard does not provide that all matters determined to be "significant risks" under PCAOB standards would be critical audit matters.[44] Some significant risks may be determined to be critical audit matters, but not every significant risk would involve especially challenging, subjective, or complex auditor judgment. To illustrate, revenue recognition is presumed to be a fraud risk and all fraud risks are significant risks;[45] however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it would not be a critical audit matter.

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[44] A significant risk is "a risk of material misstatement that requires special audit consideration." Paragraph .A5 of AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement*.

[45] *See* AS 2110.71.

c. Audit Period Covered by Critical Audit Matters

The 2013 proposal would have required the auditor to communicate critical audit matters for the audit of the current period's financial statements. Because the communication of critical audit matters for prior periods might also be useful to investors and other financial statement users in certain situations, the proposed standard provided that the auditor should consider communicating critical audit matters relating to prior periods when: (1) the prior period's financial statements are made public for the first time, such as in an initial public offering ("IPO"), or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon, such as a reaudit.

Some commenters generally supported communicating critical audit matters for only the current period's financial statements or for all periods if audited financial statements have not been made public previously. Other commenters stated that critical audit matters should be communicated for all periods presented.

The reproposal retains the requirement to communicate critical audit matters only for the current audit period. While most companies' financial statements are presented on a comparative basis, and thus most audit reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented, would provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users would be able to look at prior years' filings to analyze critical audit matters over time. However, the auditor would not be precluded from including critical audit matters for prior periods.

The reproposed standard changed the "should consider" requirement for prior periods in IPO and reaudit situations to "may" communicate critical audit matters for prior periods. This change allows the auditor to include critical audit matters for prior periods when the auditor decides it is appropriate to do so.

If the auditor's report is dual dated, the auditor would determine whether the new information for which the auditor's report is dual dated gives rise to any additional critical audit matters.

Additionally, consistent with the 2013 proposal, in situations in which a predecessor auditor has been asked to reissue its auditor's report, the communication of critical audit matters for the prior period need not be repeated. Since the communication of critical audit matters is only required for the current year, it is not required in the reissued report of the predecessor auditor for prior years. Commenters generally supported this approach.

Requirements of Other Regulators and Standard Setters

IAASB. Under the IAASB's standard, "key audit matters" are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are determined using a two-step process. First, the auditor identifies the matters communicated with those charged with governance[46] that required significant auditor attention in performing the audit, taking into account:

- Areas of higher assessed risks of material misstatement, or significant risks;
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
- The effect on the audit of significant events or transactions that occurred during the period.[47]

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters.[48] The IAASB requires the communication of key audit matters for the current period only.[49]

EU. The EU requires the auditor to describe the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud.[50] The EU does not specify the period for which these need to be described.

FRC. The FRC requires the auditor to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of

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[46] *See* paragraph 8 of ISA 701. *See also* ISA 260, *Communication with Those Charged with Governance*, which provides requirements for auditor communications with those charged with governance.

[47] *See* paragraph 9 of ISA 701.

[48] *See* paragraph 10 of ISA 701.

[49] *See* paragraphs 8 and 10 of ISA 701.

[50] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

resources in the audit; and (3) directing the efforts of the engagement team.[51] The FRC does not specify the period for which these need to be described.

Questions:

1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.

    a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?

    b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.

    c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?

    d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?

2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?

3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?

4. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than

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51 *See* paragraphs 19A of UK ISA 700 (2013).

only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?

2. Communication of Critical Audit Matters

Under the 2013 proposal, the auditor would have been required to include introductory language preceding the communication of critical audit matters and to communicate critical audit matters by identifying each matter, describing the auditor's considerations for determining that the matter was a critical auditor matter, and referring to the relevant financial statements accounts and disclosures.

Comments varied on the proposed communication of critical audit matters in the auditor's report and the level of detail the auditor should provide. While some commenters stated that the proposed requirements regarding auditor's communication of critical audit matters are sufficiently clear, many suggested improvements to some of the components of the communication requirement. Other commenters were concerned that financial statement users would not understand critical audit matters due to the lack of sufficient context about a matter briefly described in the auditor's report and the lack of knowledge regarding certain terms used to describe a critical audit matter. After consideration of comments, the Board has made a number of changes, as described below.

a. Introductory Language

The reproposed standard retains the requirements to include in the auditor's report a section titled "Critical Audit Matters" and specific language preceding the description of critical audit matters. However, the specific language has been simplified and aligned with the reproposed definition of a critical audit matter.

Some commenters stated that the communication of critical audit matters in the auditor's report could undermine the auditor's pass/fail opinion on the financial statements, taken as a whole, by leading some investors to believe that the auditor is qualifying the report in the areas of the critical audit matters or expressing a separate opinion on each critical audit matter. In response to comments and to reduce the risk of such a misunderstanding, the introductory language in the critical audit matter section of the auditor's report has been modified in the reproposed standard to expressly state that the auditor is not providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate.

The reproposed standard retains the note contained in the 2013 proposal stating that language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. In response to comments, the note also clarifies that the language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates. In addition, the reproposed standard makes clear that the auditor's report contains an expression of opinion on the financial statements, taken as a whole.

b. Communication Requirement

Under the 2013 proposal, for each critical audit matter, the auditor would have been required to:

- Identify the critical audit 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 critical audit matter.

The communication requirements are retained from the 2013 proposal, with the addition of a requirement to describe how the critical audit matter was addressed in the audit. Additionally, certain language has been modified in response to commenters and aligned with the reproposed definition of a critical audit matter.

Under the reproposed standard, the auditor would be required to:

- Identify the critical audit matter;
- Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- Describe how the critical audit matter was addressed in the audit; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

Identify the Critical Audit Matter and Describe the Principal Considerations that led the Auditor to Determine that the Matter is a Critical Audit Matter

Some commenters stated that a requirement to describe all the considerations that led the auditor to determine that a matter is a critical audit matter could lead to a checklist approach, which could result in standardized or boilerplate language and diminish the value of critical audit matters. These commenters suggested that the description should be limited to the principal or primary considerations.

In response to comments, the reproposed standard clarifies that the auditor is required to describe only the principal considerations that led the auditor to determine that the matter is a critical audit matter. The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication would be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.

Describe How the Critical Audit Matter was Addressed in the Audit

Some commenters suggested adding a requirement to describe how each critical audit matter was addressed in the audit because this would be of interest to users and consistent with the objective of providing more information about the audit. However, other commenters stated that including audit procedures in the description of a critical audit matter would not necessarily make the auditor's report more informative and useful. Additionally, some commenters suggested that certain specific procedures, such as consultations with the auditor's national office or the use of specialists, should not be mentioned.

In response to comments, the reproposed standard includes a new requirement for the auditor to describe how each critical audit matter was addressed in the audit. Because of differing commenter views about the description of how each critical audit matter was addressed in the audit, the reproposed standard does not prescribe a specific way to meet this requirement. For example, in describing how the critical audit matter was addressed in the audit, the auditor may describe: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements.[52] If the auditor provides an indication of the outcome of the auditor's procedures in the description of a critical audit matter, language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates. It is also not appropriate for the auditor to use language that could call into question the auditor's opinion on the financial statements, taken as a whole.

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[52] These elements are similar to the IAASB's elements described in paragraph A46 of ISA 701. The EU also requires that the auditor describe key observations with respect to the most significant assessed risks of material misstatement.

While the description of how the critical audit matter was addressed in the audit would require judgment, the auditor should bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company's financial statements that would be useful to investors. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.

Refer to the Relevant Financial Statement Accounts and Disclosures that Relate to the Critical Audit Matter

The reproposed auditor reporting standard also would require the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

Illustrative Examples of the Communication of Critical Audit Matters

The examples below are based on hypothetical situations for two different companies and have been prepared for illustrative purposes only to show how a critical audit matter could be communicated in the auditor's report. They are not intended to provide guidance or any suggestions regarding the number of critical audit matters or the accounting or auditing in the circumstances presented. Additionally, the description of a critical audit matter is not intended to provide a list of all audit procedures performed.

Company A
Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Allowance for Loan Losses – New Loan Product

As more fully described in Note 7 to the financial statements, during 2014, the Company [a mid-size regional bank] began actively marketing a nine-year auto loan in addition to the three- and five-year auto loans historically marketed. At December 31, 2015, the nine-year loans represented approximately 18% of the auto loan portfolio. The Company estimates and records an allowance for loans that are impaired but are not yet specifically identified (collective impairment allowance) by developing a loss rate based on historical losses and other factors, including qualitative adjustments to historical loss rates based on relevant market factors. Since management has limited historical loss data for the nine-year loans, it developed a new model to estimate this allowance using historical loss data from its auto loans of shorter terms and loss data from external sources for auto loans of longer terms to model a loss rate for the nine-year loans. In addition, management made qualitative adjustments to the historical loss rates to reflect lower borrower quality and higher risk of collateral impairment compared to its shorter term loans and for economic factors, primarily due to increasing unemployment in the markets served. There was a significant amount of judgment required by management when developing the model, which in turn involved our significant judgment.

The principal considerations for our determination that the allowance for loan losses for nine-year auto loans is a critical audit matter are that it is a new loan product with limited historical loss data and auditing the estimated allowance for losses on these loans involved our complex and subjective judgment.

Our audit procedures related to the collective impairment allowance for the nine-year loans included the following procedures, among others.

We tested the effectiveness of controls over the Company's new model, historical loss data, and the calculation of a loss rate. We also evaluated the qualitative adjustment to the historical loss rates, including assessing the basis for the adjustments and the reasonableness of the significant assumptions. We tested the accuracy and evaluated the relevance of the historical loss data as an input to the new model.

We used a specialist to assist us in evaluating the appropriateness of the new model and to review the loss data from external sources used by the Company to determine its relevance to the Company's nine-year loan portfolio and consistency with external data from other sources. Finally, with the assistance of the specialist, we evaluated the incorporation of the applicable assumptions into the model and tested the model's computational accuracy.

Company B
Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Accounting for Acquisitions
Refer to Notes 2 and 13 to the financial statements

The Company's strategy includes growth by acquisition. Acquisitions represent a significant component of the Company's sales growth through the addition of new customers and new products. During 2015 the Company completed eight acquisitions for net consideration of $2.1 billion. The most significant of these were (1) the acquisition of all outstanding equity of ABC Inc. for net consideration of $1.1 billion and (2) the acquisition of all outstanding equity of XYZ Corp. for net consideration of $0.5 billion.

Auditing the accounting for the Company's 2015 acquisitions involved a high degree of subjectivity in evaluating management's estimates, such as the recognition of the fair value of assets acquired and liabilities assumed. We planned and performed the following procedures in connection with forming our overall opinion on the financial statements. We tested controls over the accounting for acquisitions, such as controls over the recognition and measurement of assets acquired, liabilities assumed, and consideration paid and payable, including contingent consideration. For each of the acquisitions, we read the purchase agreements, evaluated the significant assumptions and methods used in developing the fair value estimates, and tested the recognition of (1) the assets acquired and liabilities assumed at fair value; (2) the identifiable acquired intangible assets at fair value; and (3) goodwill measured as a residual.

More specifically, for the acquisitions of ABC and XYZ, we assessed whether (1) intangible assets, such as acquired technology, customer lists, and noncompetition agreements, were properly identified, and (2) the significant assumptions, including discount rates, estimated useful lives, revenue growth rates, projected profit margins, and the expected rate of return, used in valuing these intangibles were reasonable. Specifically, when assessing the assumptions related to the revenue growth rate and projected profit margins, we evaluated whether the assumptions used were reasonable considering the past performance of ABC and XYZ and the Company's history related to similar acquisitions and considered whether they were consistent with evidence obtained in other areas of the audit, such as assumptions used by the Company in its budget.

The purchase consideration for the acquisitions of ABC and XYZ also reflected, in part, the estimated fair value of significant contingent consideration arrangements based on attainment of product development milestones and patent approvals. In testing the valuation of contingent consideration, we assessed the terms of the arrangements and the conditions that must be met for the arrangements to become payable. Finally, we evaluated management's classification of contingent payments to continuing employees as either contingent consideration in the business combination or employee compensation.

c. Additional Considerations Related to the Communication Requirement

Some commenters expressed concerns that the proposed requirement to communicate critical audit matters would undermine the role of the audit committee or management by requiring the auditor to disclose information about the company's financial statements that would typically be management's responsibility to disclose. Since the auditor would be communicating information regarding the audit rather than information directly about the company and its financial statements, the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for the company's disclosure of financial information. In addition, communicating critical audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

Many commenters also stated that the communication of critical audit matters in areas where the company has no current reporting obligation could result in the auditor disclosing confidential information about the company or effectively imposing on management a lower disclosure threshold that would go beyond the applicable financial reporting framework or SEC reporting requirements. Some commenters raised concerns that the communication of critical audit matters would cause harm by requiring auditors to disclose confidential information about the company.

In addition to revising the definition of a critical audit matter to require that the matter relate to accounts and disclosures that are material to the financial statements, the reproposed standard adds a note to address commenters' concerns about the auditor becoming the source of original (and potentially confidential) information about the company. The note indicates that when describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company[53] unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit. For example, in describing the principal considerations that led the auditor to determine that revenue recognition is a critical audit matter, it is possible that the auditor could provide more information than is provided in management's disclosures. In circumstances when information about the company has not previously been made publicly available, management may decide that additional management disclosures would be useful to

[53] Companies make information publicly available in a variety of ways, including the annual report, press releases, or other public statements.

financial statement users. However, management's decision about whether to disclose additional information does not affect the auditor's responsibility to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Some commenters suggested that the standard should provide guidance on how the auditor should correct errors or misstatements in the reporting of critical audit matters, such as an incorrect or incomplete description of a critical audit matter or the omission of a critical audit matter from the auditor's report. In principle, auditors should approach such errors and misstatements in the same way they would approach any other error or misstatement in the auditor's report that does not affect the auditor's opinion or the ability of market participants to rely on the opinion.[54] It appears that under current practice, SEC filings have been amended solely to correct errors in auditor's reports, such as missing firm signatures, incorrect auditor's report dates, or missing explanatory paragraphs.[55]

d. Ability to Communicate No Critical Audit Matters

The reproposed standard retains from the 2013 proposal the possibility that the auditor could determine that there are no critical audit matters and, if so, would include a statement to that effect in the "Critical Audit Matters" section of the auditor's report.[56] A commenter suggested that having no critical audit matters should be rare and that each auditor's report should have at least one critical audit matter to communicate.

The determination of critical audit matters would be based on the facts and circumstances of each audit. The Board expects that, in most audits to which the requirement to communicate critical audit matters would apply, the auditor would

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[54] The reproposed standard indicates that the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole.

[55] PCAOB staff reviewed amended annual report filings on SEC Form 10K/A from 2011–2013 and identified 52 instances where the company disclosed that it amended the annual report solely to correct errors in the auditor's report without other changes to the financial statements or other disclosures.

[56] Since communication of critical audit matters would not be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5; investment companies other than business development companies; and benefit plans, the auditor's report for the audits of these entities would not be required to include the statement that there are no critical audit matters.

determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. There may be critical audit matters even in an audit of a company with limited operations or activities. However, there may be circumstances in which the auditor determines there are no matters that meet the definition of a critical audit matter and, in those circumstances, the auditor would communicate that there were no critical audit matters.

Requirements of Other Regulators and Standard Setters

IAASB. For each key audit matter, the IAASB requires the auditor to reference the related disclosures, if any, in the financial statements and address: (1) why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter and (2) how the matter was addressed in the audit.[57] The IAASB allows the auditor to determine that there are no key audit matters to communicate in the auditor's report and, if so, requires a statement to this effect.[58]

EU. The EU requires the auditor to include in the auditor's report: (1) a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud; (2) a summary of the auditor's response to the risks; and (3) where relevant, key observations arising with respect to the risks.[59]

FRC. The FRC requires the auditor, among other things, to: (1) describe those assessed risks of material misstatement that were identified by the auditor and (2) provide an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement.[60] The explanations of the matters set out in the auditor's report should be described in a way that: (1) enables a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements; (2) enables the matters to be related directly to the specific circumstances of the audited entity and are not therefore generic or abstract matters

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[57] *See* paragraph 13 of ISA 701.

[58] *See* paragraphs 14 and 16 of ISA 701.

[59] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

[60] *See* paragraph 19A of UK ISA 700 (2013).

expressed in standardized language; and (3) complements the description of significant issues required to be made by the audit committee.[61]

Questions:

5. Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?

6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:

   a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and

   b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?

   Are there other steps the Board could take to address these concerns? If so, what are they?

7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?

8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?

3. Documentation of Critical Audit Matters

Under the 2013 proposal, documentation would have been required for each reported critical audit matter, as well as matters that "appeared to meet" the definition of

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61 *See* paragraph 19B of UK ISA 700 (2013).

a critical audit matter but were determined not to be critical audit matters and thus not reported. Some commenters generally supported documenting the matters that were determined to be critical audit matters. One of these commenters stated that the documentation should focus on why matters are of such importance that they are included in the auditor's report. Several commenters expressed concern that the documentation requirement for non-reported matters, which are matters that would appear to meet the definition of a critical audit matter but were determined not to be critical audit matters, was too broad and not aligned with current audit documentation requirements.

The reproposed definition of a critical audit matter narrows the source of critical audit matters to matters communicated or required to be communicated to the audit committee and adds a materiality component. Thus, under the reproposed standard, auditors would be required to document the basis for the auditor's determination whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved or did not involve especially challenging, subjective, or complex auditor judgment. This approach should address, at least in part, commenters' concerns about the proposed documentation requirement because the potential population of matters that may need to be documented has been narrowed. The documentation requirement would also facilitate the review by the engagement quality reviewer.[62]

The auditor could comply with the documentation requirement in a variety of different ways. For example, the auditor could start with the communications to the audit committee, which are already documented, identify which of those matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether each matter involved especially challenging, subjective, or complex auditor judgment. In documenting the basis for the determination, the auditor may include the factors the auditor took into account. This documentation may be prepared as an extension to the audit committee documentation or the auditor may prepare separate documentation.

The amount of documentation required could vary with the circumstances. For example, the auditor's basis for the determination may be so clear for some matters that

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[62] Under the existing audit documentation requirement, audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. *See* paragraph .02 of AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*.

a single sentence would be sufficient, while other matters may require more extensive documentation. Additionally, the description of a critical audit matter in the auditor's report would generally suffice as documentation for matters determined to be critical audit matters.

Requirements of Other Regulators and Standard Setters

The IAASB requires the auditor to document the matters that required significant auditor attention and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter.[63] The EU does not include documentation requirements for expanded auditor reporting. The FRC does not include specific documentation requirements related to expanded auditor reporting.[64]

Question:

9. Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?

4. Liability Considerations Related to Critical Audit Matters

In the 2013 proposal, the Board acknowledged that, by disclosing critical audit matters, the auditor would be making new statements in the auditor's report that could raise potential liability concerns. As discussed in that release, liability may be imposed on auditors under a number of different legal theories depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, and various state law causes of action. The Board specifically sought comment on what effect the communication of critical audit matters would have on private liability and whether there were any steps the Board could or should take to address any likelihood of an increase in potential liability in private litigation.

The potential for increased auditor liability was cited as a concern by a number of commenters on the Board's 2013 proposal. Several commenters expressed concerns that investors who suffer a financial loss could assert legal claims against the auditor based on their reliance on the auditor's statements in the auditor's report regarding critical audit matters. These commenters suggested, for example, that an investor that

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63 *See* paragraph 18(a) of ISA 701.

64 General documentation requirements appear in ISA (UK and Ireland) 230, *Audit Documentation*.

suffered a loss following a decline in the issuer's stock price could assert that the auditor made a material misstatement regarding a critical audit matter, made a statement about a critical audit matter that made the auditor's other statements in the auditor's report misleading, or omitted a critical audit matter from the auditor's report. It should be noted that any such claimant would have to establish all of the elements of a claim (for example, when applicable, loss causation and reliance).

Some commenters raised more specific liability concerns about critical audit matters. One commenter argued that plaintiffs may attempt to use critical audit matters as de facto admissions of uncertainty or even error. Several commenters asserted that the lack of clarity or elements of judgment in the process of determining critical audit matters would make it easy for a plaintiff to claim in hindsight that an audit matter should have been disclosed as a critical audit matter. Others argued that auditors, to avoid being second-guessed, would have the incentive to identify too many critical audit matters in an effort to protect themselves from liability.

Other commenters claimed that the fact-specific nature of critical audit matters or of certain potential elements of the description of critical audit matters, such as the audit procedures used, would make it difficult to obtain early dismissal of claims. In their view, this could support meritless claims, potentially undermining the stringent pleading standards of the Private Securities Litigation Reform Act of 1995, which were intended to curtail nonmeritorious claims against auditors and avoid the costs and burdens associated with them. Information provided regarding critical audit matters could also affect other aspects of securities fraud claims (for example, by potentially undercutting a claim of reliance).

Several commenters highlighted the proposed requirement to document the auditor's determination that a matter was not a critical audit matter as increasing litigation risk with respect to such matters. As one of these commenters explained, the proposed documentation requirement could create a detailed documentary record of the auditor's determination that a matter was not "critical" and therefore give rise to increased litigation risk with respect to any "identified but not determined to be critical" matter.

Some commenters argued that critical audit matters could also increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, and plaintiffs may attempt to use critical audit matters as a "road map" for litigation against the company.

On the other hand, one commenter asserted that communicating critical audit matters conceptually could decrease auditor and company legal exposure when the accounting in the areas of the critical audit matters is subsequently challenged, because the communication of critical audit matters is about disclosure of risks and challenges.

The commenter further stated that the noncommunication of such matters would be more problematic from a litigation point of view.

Many of the commenters that expressed concerns about the potential for increased auditor liability also suggested changes to the 2013 proposal that, in their view, would reduce the liability impact of critical audit matters determination and communication. For example, several commenters suggested ways to limit and clarify the process for determining critical audit matters, such as narrowing the source of critical audit matters to matters communicated to the audit committee, incorporating the concept of materiality, and refining the factors used to determine critical audit matters. Commenters also suggested changes to the proposed communication requirements, such as requiring communication of only the principal considerations that led the auditor to determine a matter was a critical audit matter, rather than all considerations; prohibiting auditor reporting of information not required to be disclosed by the company; and clarifying the auditor's statements about the nature of critical audit matters. The Board has taken these commenter suggestions for reducing potential incremental liability into account in formulating the reproposal (for example, modifying the source of critical audit matters, adding a materiality component, refining the factors, and modifying the communication requirement).

Questions:

10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?

11. Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?

12. Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?

B. Additional Improvements to the Auditor's Report

The 2013 proposal provided a list of basic elements to be included in every auditor's report. Some of these basic elements, such as the auditor's opinion, identification of the financial statements audited, and management's and auditor's responsibilities, were drawn from the existing auditor reporting standard.[65] Other basic

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[65] *See* AS 3101.06–.08.

elements, such as the name of the company under audit and the date of the financial statements, were incorporated from existing illustrative auditor's reports. Commenters broadly supported these basic elements and they are being reproposed substantially as proposed.

1. Clarification of Existing Auditor's Responsibilities

The 2013 proposal included requirements that would enhance standardized language of the auditor's report by clarifying the nature and scope of the auditor's existing responsibilities, such as a new statement regarding auditor independence and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the proposal included a requirement intended to promote uniformity with respect to the addressee of the report.

a. Auditor Independence

The proposed standard would have required the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC[66] and the PCAOB.[67]

Some commenters stated that the statement regarding auditor independence would provide useful information to investors and other financial statement users and could enhance an investor's understanding of the auditor's role. Other commenters preferred a more definitive statement on auditor independence, such as stating that the auditor is in fact independent and in compliance with applicable independence rules. Yet other commenters stated that the statement would be redundant with the title of the auditor's report or could distract from the main objective of the auditor's report.

The Board considered the comments and is retaining the statement regarding auditor independence as originally proposed.[68] The independence statement in the

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[66] *See* SEC Rule 2-01 of Regulation S-X, 17 CFR 210.2-01.

[67] *See* PCAOB Rule 3520, *et seq*.

[68] In situations in which an auditor that is not registered with the Board is required by law to, or voluntarily agrees to, perform an audit in accordance with PCAOB standards, there may be certain modifications to the auditor's report, such as the title and the statement regarding independence requirements. If the Board adopts the

auditor's report could both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations. The statement regarding auditor independence is not intended to, and would not, affect auditor independence requirements under the securities laws, SEC rules, or PCAOB rules.

Requirements of Other Regulators and Standard Setters

The IAASB requires that the auditor's report include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.[69] The EU requires a statement in the auditor's report that the auditor remained independent of the audited entity in conducting the audit.[70] The FRC requires the auditor to state that the auditor is required to comply with the United Kingdom's ethical standards for auditors, which include requirements regarding auditor independence.[71]

Question:

13. Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?

b. Addressee

Under the existing standard, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[72] Under current practice, the auditor's report is generally addressed to

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reproposed standard, the staff will provide guidance for these situations, such as by updating Staff Questions and Answers, *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board.*

[69] *See* paragraph 28(c) of ISA 700.

[70] *See* requirements in 2(f) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

[71] *See* paragraph 15 of UK ISA 700 (2013).

[72] *See* AS 3101.09.

one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[73]

To promote consistency in addressing the auditor's report to the company's investors, the proposed standard would have required the auditor's report to be addressed to: (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. The proposed standard stated that addressees would not necessarily be limited to these parties and might include other appropriate parties depending on, for example, the legal and governance structure of the company.

Some commenters generally supported the requirement as proposed. Other commenters expressed concerns that requiring or suggesting that the auditor's report be addressed to other parties besides the board of directors and shareholders, such as bondholders, could adversely affect auditors' legal posture in some types of legal proceedings. In particular, these commenters were concerned that the additional addressees might gain the ability to assert direct state law claims against the auditor in some circumstances.

In response to these comments and to promote greater uniformity in the addressees of the auditor's report, the reproposed standard would limit required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations.[74] Auditors would retain the option to include additional addressees.

Requirements of Other Regulators and Standard Setters

The IAASB requires that the auditor's report be addressed as appropriate, based on the circumstances of the engagement.[75] The EU does not specify the addressee of the auditor's report. The FRC requires that the auditor's report be addressed as required

[73] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers and brokers and dealers.

[74] For example, for benefit plans, an addressee equivalent to shareholders is the plan participants; for issuers organized as trusts, an addressee equivalent to the board of trustees.

[75] *See* paragraph 22 of ISA 700.

by the circumstances of the engagement.[76] UK auditor's reports are typically addressed to either the members or the shareholders of the company.[77]

Questions:

14. Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?

15. Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?

c. Enhancements to the Basic Elements

The 2013 proposal would have changed the language for certain elements in the existing auditor's report. These proposed elements included:

- *Financial statement notes*—The identification of the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.[78] Under the existing standard, the notes to the financial statements and the related schedules are not identified as part of the financial statements.

- *Error or fraud*—A description of the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the

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[76] *See* paragraph 13 of UK ISA 700 (2013).

[77] *See* paragraph A5 of UK ISA 700 (2013).

[78] The proposed and reproposed standards use the term "financial statements" to include all notes to the statements and all related schedules, as used under SEC rules that apply to issuers. *See* Section 1-01(b) of Regulation S-X, 17 CFR 210.1-01(b), which states in part, "the term financial statements . . . shall be deemed to include all notes to the statements and all related schedules." The reproposed standard would not apply to schedules included as supplemental information, as defined in AS 2701 (currently Auditing Standard No. 17), *Auditing Supplemental Information Accompanying Audited Financial Statements*, because those schedules are not considered part of the financial statements. The auditor should continue to look to the requirements of AS 2701 for the auditor's reporting responsibilities regarding supplemental information accompanying audited financial statements.

financial statements are free of material misstatements, whether caused by error or fraud.[79] The existing standard does not require the auditor's report to contain the phrase *whether due to error or fraud*.

- *Nature of the audit*—The description of the nature of the audit reflected the auditor's responsibilities in a risk-based audit and aligned the description with the language in the Board's risk assessment standards, including:

  - o Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

  - o Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;

  - o Evaluating the accounting principles used and significant estimates made by management; and

  - o Evaluating the overall presentation of the financial statements.

Commenters generally supported the proposed language for these basic elements of the auditor's report. Some commenters objected to the inclusion of the phrase *whether due to error or fraud*, saying it could provide a false sense of security to financial statement users and a perceived transfer of responsibility from management in preventing and detecting fraud, thus exposing companies to greater risk of fraud and unintentionally increasing auditor liability. However, under existing standards, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[80] Therefore, this element is retained in order to clarify the auditor's existing responsibilities in this area.

The reproposed standard retains these basic elements substantially as proposed.

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[79] *See* paragraph .02 of AS 1001 (currently AU sec. 110), *Responsibilities and Functions of the Independent Auditor*.

[80] *See* AS 1001.02.

2. Auditor Tenure

The 2013 proposal would have required the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. Currently information about auditor tenure is not required to be communicated to investors by the auditor, management, or the audit committee.[81] However, as discussed below, there is a growing trend toward voluntarily disclosure of auditor tenure. The intent of the reproposed requirement, consistent with the 2013 proposal, is to require consistent reporting of the duration of the auditor's relationship with the company and have this information in a consistent location—the auditor's report.

a. Disclosure of Tenure

Some commenters opposed a requirement to disclose auditor tenure in the auditor's report on the basis that such disclosure could result in false conclusions about correlations between auditor tenure and audit quality. These and other commenters suggested that tenure could be disclosed in the firm's annual report filed with the PCAOB, the company's proxy statement, or elsewhere. Some commenters were concerned that, in the illustrative report, auditor tenure placed next to the statement on auditor independence may imply a relationship between auditor independence and tenure of service.

Other commenters asserted that information regarding auditor tenure would be useful to financial statement users, for example, in understanding the audit committee's oversight of the auditor or in deciding whether to vote to ratify the appointment of the auditor. Recent analysis of corporate proxy statements for annual meetings of shareholders has found that a growing number of companies are disclosing auditor tenure,[82] presumably due to interest from investors. However, such voluntary

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[81] Investors may manually review company filings on the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") to determine when the company changed auditors. For example, although company filings are not available via EDGAR prior to 1994, investors may review a company's periodic filings since that time or any Form 8-K filings in EDGAR. *See* 17 CFR 249.308, Item 4.01 Changes in Registrant’s Certifying Accountant. Not all companies are required to file Form 8-K. Information about auditor tenure may be less accessible for investment companies and brokers and dealers, which have different SEC filing requirements.

[82] The Center for Audit Quality, together with Audit Analytics, reviewed corporate proxies filed through the end of June 2015 and 2014 of 1,500 Standard and Poor's ("S&P") Composite companies. Their analysis identified that in 2015 and 2014 auditor tenure was disclosed in the annual proxy statements of 54 and 47 percent of the

information may not be disclosed in the same location in the proxy statement; for instance, some disclosures are in the audit committee report while others are in another section of the proxy.[83] Further, the proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, brokers and dealers, and most investment companies are not required to prepare proxy statements. The SEC has explored through a concept release the potential of requiring disclosure of auditor tenure in the audit committee report.[84] The Board will continue to monitor developments on the SEC concept release.

While commenters' views and academic research[85] continue to be divided on the relationship of auditor tenure and audit quality, the Board is reproposing to include auditor tenure[86] to make this data point readily available in the auditor's report. Requiring the disclosure of auditor tenure in the auditor's report would ensure that the disclosure is in a consistent location—the auditor's report—for all companies and would reduce search costs for investors and other financial statement users who are interested in this piece of information. The standard does not specify a required location within the auditor's report for the statement on auditor tenure. The illustrative report in the reproposed standard includes the statement on auditor tenure at the end of the

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S&P 500 large-cap companies, respectively, 44 and 42 percent of the S&P MidCap 400 companies, respectively, and 46 and 50 percent of the S&P SmallCap 600 companies, respectively. *See* Center for Audit Quality and Audit Analytics, *2015 Audit Committee Transparency Barometer* (Nov. 3, 2015). Separately, during their review of proxy statements of Fortune 100 companies, Ernst & Young identified that 59 percent of the companies reviewed voluntarily disclosed auditor tenure in 2015 compared to 50 percent in 2014, 30 percent in 2013, and 25 percent in 2012. *See* Ernst & Young, *Let's Talk: Governance—Audit Committee Reporting to Shareholders 2015 Proxy Season Review* (Sept. 2015).

[83] *See* Center for Audit Quality and Audit Analytics, *2015 Audit Committee Transparency Barometer* (Nov. 3, 2015).

[84] *See* SEC, *Possible Revisions to Audit Committee Disclosures*, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015) ("SEC concept release").

[85] *See* Section VI.D.2.e for a discussion of academic research regarding auditor tenure.

[86] The statement regarding the auditor's tenure would include the year the firm, rather than the engagement partner, began serving consecutively as the company's auditor.

auditor's report, after the signature of the firm. However, the auditor may choose another location in the auditor's report.

The Board is also seeking comment on whether disclosure of auditor tenure would be more appropriately made by the auditor in another location, specifically the Board's Form AP, *Auditor Reporting of Certain Audit Participants*, ("Form AP") rather than in the auditor's report. Recently, the Board adopted Form AP, which, assuming final approval by the SEC, will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.[87]

b. Determination of Tenure

Some commenters stated that histories of mergers and acquisitions, involving both audit firms and companies, may make it challenging for the auditor to determine auditor tenure. The reproposed standard retains a note from the 2013 proposal that states that if there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

Additionally, the auditor's relationship with the company is not affected by the company's status as a public company. For instance, if a company went public but maintained its auditor, the auditor tenure would include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Several commenters stated that clarification should be provided regarding applying the auditor tenure disclosure to investment companies because of the unique structure of investment companies, which are often organized as an investment company complex.[88] These commenters suggested that, since an investment company complex may include many investment companies with different inception dates,

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[87] *See Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015-008 (Dec. 15, 2015).

[88] *See* SEC Rule 2-01(f)(14)(i) of Regulation S-X, 17 CFR 210.2-01(f)(14)(i) for the definition of an investment company complex, which includes not only investment companies but also investment advisers, private investment companies, and other entities.

disclosure of auditor tenure should be the same for each investment company in the investment company complex and measured from the date the auditor first audited any investment company in the complex. In response to comments, the reproposed standard requires that, for an investment company that is part of a group of investment companies,[89] the auditor's statement regarding tenure would contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies.[90] For example, if Firm A has been auditing investment companies in XYZ group of investment companies since 1980, the current auditor's report for XYZ fixed income fund, whose inception date was in 2010, would state that Firm A has served as the auditor of one or more XYZ investment companies since 1980. This disclosure would provide information on the length of the auditor's relationship with the group of investment companies because of common control at the group level.

Requirements of Other Regulators and Standard Setters

The EU requires a statement in the auditor's report that indicates the total uninterrupted engagement period, including previous renewals and reappointments of the statutory auditors or the audit firms.[91] The IAASB and the FRC do not include a similar requirement.

Questions:

16. Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information

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[89] A group of investment companies means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. *See* Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"). The term "group of investment companies" is used to indicate that auditor tenure would be measured from the start of the relationship between the auditor and the management of any registered investment company in the group and not with respect to other entities that may be part of an investment company complex, such as investment advisers or private investment companies.

[90] The following is an example of such statement: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

[91] *See* requirements in 2(b) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

in the auditor's report which the Board should consider? If so, what are they?

17. Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?

18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?

19. Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?

3. Additional Basic Elements Suggested by Commenters

As part of the proposal, the Board considered potential additional elements in the auditor's report. The Board received little comment on additional elements; however, two commenters suggested that the following elements should be included in the auditor's report:

- A statement that the procedures performed and the audit evidence obtained provide a reasonable basis for the opinion;

- A statement that the references to the financial statements throughout the auditor's report relate to the financial statements, taken as a whole;

- An expanded description of the responsibilities of management, including a description of the responsibilities of the audit committee with respect to the financial statements;

- A description of the meaning of reasonable assurance; and

- A description of the auditor's use of professional judgment and professional skepticism throughout the audit.

Since it may not be practical to describe these elements concisely, adding these to the auditor's report would unnecessarily lengthen it without providing additional useful information to investors. As a result, the reproposed standard does not include these additional elements.

A commenter also suggested that the auditor's report should include a discussion of materiality and how it is used by the auditor in the audit as well as the related dollar amount.[92] Other commenters from the Board's initial outreach stated that disclosing materiality levels in the auditor's report could have negative implications on audit quality by reducing the element of surprise necessary in an audit.[93] In addition, investors did not evidence a strong demand for reporting materiality levels in the auditor's report.[94] For these reasons, the reproposed standard does not require this element.

Question:

20. Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?

C. Explanatory Language and Emphasis of a Matter

1. Explanatory Language Required by Other PCAOB Standards

The proposed standard, similar to the existing standard,[95] provided a list of circumstances in which the auditor would have been required to add explanatory language to the auditor's report and included references to other PCAOB standards in which these circumstances and related reporting requirements are described. These circumstances include when there is substantial doubt about the company's ability to continue as a going concern and a restatement of previously issued financial statements, among others.

Commenters generally supported providing in the proposed standard a list of circumstances that require explanatory language in the auditor's report on the basis that keeping this information in a single place would facilitate consistency in execution. The

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[92] Such a requirement would be similar to the FRC requirement that the auditor provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. *See* paragraph 19A of UK ISA 700 (2013).

[93] *See* PCAOB Release No. 2011-003, Appendix C, for a detailed discussion of the staff's outreach regarding reporting materiality levels.

[94] *Id.*

[95] *See* AS 3101.11.

reproposed standard retains the list of explanatory paragraphs and related references substantially as proposed.

In the 2013 proposal, the Board sought comment on whether to require new explanatory language in the auditor's report in cases where the company is required to report on internal control over financial reporting ("ICFR") but has determined that it is not required to obtain, and did not request the auditor to perform, an audit of ICFR.[96] Commenters supported such a requirement because it would help to clarify the auditor's responsibility when there is no auditor's report on ICFR. Under current standards, auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.[97] The Board understands that, in practice, the auditor often includes a statement in the auditor's report to clarify the auditor's responsibilities when the company has not engaged the auditor to perform an audit of the company's ICFR.[98] The reproposed standard includes a reference to a new proposed requirement in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*,[99] for the auditor to add such explanatory language.

PCAOB staff has also observed that auditor's reports of investment companies often include similar statements. The Board is seeking comment whether the auditor should be required to include an explanatory paragraph in all cases, even in situations when management has no requirement to report on ICFR.

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[96] This may be the case for companies that are subject to Section 404(a) of Sarbanes-Oxley, which mandates management ICFR reporting, but not Section 404(b), which mandates auditor ICFR reporting. Section 404(a) generally applies to companies that are subject to the reporting requirements of the Exchange Act, other than registered investment companies. Certain categories of companies that are subject to Section 404(a), such as non-accelerated filers and emerging growth companies, are not subject to Section 404(b).

[97] *See* paragraph 10 of AI 20, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710* (currently AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*).

[98] Based on the PCAOB's staff review of a sample of 1,169 auditor's reports for nonaccelerated filers for fiscal year 2014, approximately 83 percent included a statement generally consistent with the reproposed requirement.

[99] *See* reproposed amendments to AS 3105.59–.60.

Interaction between critical audit matters and explanatory paragraphs. The 2013 proposal stated that communication of critical audit matters would not alter existing requirements to add explanatory language and that the same matter could be described both in the critical audit matter section and using explanatory language with a cross-reference, as appropriate. A commenter stated that, in a circumstance in which a matter constitutes a critical audit matter and requires an explanatory paragraph, the discussion in the auditor's report should be integrated to avoid duplication and repetitiveness. Other commenters suggested not requiring an explanatory paragraph if the same matter is already communicated as a critical audit matter.

The reproposed standard clarifies that critical audit matters are not a substitute for required explanatory paragraphs. However, there could be situations in which a matter meets the definition of a critical audit matter and also requires an explanatory paragraph, such as going concern. For these situations, both the explanatory paragraph and the required communication regarding the critical audit matter would be provided. The auditor may include the communication requirements of a critical audit matter in the explanatory paragraph with a cross-reference in the critical audit matter section to the explanatory paragraph. Alternatively, the auditor may choose to provide both an explanatory paragraph and the critical audit matter communication separately in the auditor's report with a cross-reference between the two sections. While the information reported in a critical audit matter may be redundant of some of the information already provided in the explanatory paragraph, the critical audit matter would provide incremental information, such as how the matter was addressed in the audit.

2. Emphasis of a Matter

The 2013 proposal, similar to the existing standard, provided the ability for the auditor to add a paragraph to the auditor's report to emphasize a matter regarding the financial statements ("emphasis paragraph").[100] Emphasis paragraphs are not required but may be used by auditors to draw the reader's attention to matters, such as significant transactions with related parties and unusually important subsequent events. Under the proposal, emphasis paragraphs would have referred only to information presented or disclosed in the financial statements. The proposed standard provided a list of examples primarily from existing standards.

Commenters broadly supported retaining the auditor's ability to emphasize a matter in the financial statements. The reproposed standard retains emphasis paragraphs substantially as proposed and retains most of the proposed examples.[101]

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[100] *See* AS 3101.19.

[101] The reproposed standard does not retain the example emphasis paragraph regarding retroactive application of the prospective change in accounting

While the reproposed standard provides examples of potential matters that the auditor may emphasize in the auditor's report, the auditor may also decide to emphasize other matters in the financial statements if the auditor determines it is appropriate to do so. Additionally, the reproposed standard removes the sentence stating that an emphasis paragraph refers only to information presented or disclosed in the financial statements since this is not specified under the existing standard and the reproposed standard does not intend to change current practice.

Interaction between critical audit matters and emphasis paragraphs. Under the 2013 proposal, communication of critical audit matters would not have altered the auditor's ability to add an emphasis paragraph to the auditor's report. Some commenters suggested that the standard should address the relationship between critical audit matters and emphasis paragraphs. The reproposed standard states that emphasis paragraphs are not a substitute for required critical audit matters. The Board notes that critical audit matters are required and emphasis paragraphs are included only at the discretion of the auditor. The reproposed standard provides a list of examples of matters that the auditor may emphasize regarding the financial statements. However, if a matter that the auditor considers emphasizing meets the definition of a critical audit matter, the auditor would be required to identify the matter as a critical audit matter in the auditor's report and would be subject to the other communication requirements for critical audit matters. The auditor would not be expected to include an emphasis paragraph in the auditor's report about a matter that meets the definition of a critical audit matter.

Requirements of Other Regulators and Standard Setters

Under the requirements of other regulators and standard setters, there are no analogous explanatory paragraphs, except for reporting on going concern. The Board's reproposed approach is similar to the IAASB's approach to the interaction between a paragraph regarding the company's ability to continue as a going concern and key audit matters, although the underlying requirements for auditor reporting on going concern vary.[102] Under the IAASB's approach, an emphasis of matter paragraph is not required

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principle. This example was included in AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretation of Section 410*, which has been rescinded as part of the reorganization of PCAOB auditing standards. *See* PCAOB Release 2015-002.

[102] *See* paragraph A1 of ISA 570, *Going Concern*, and paragraph 15 of ISA 701.

for a matter that was determined to be a key audit matter.[103] The EU and the FRC have separate requirements related to going concern reporting that do not specifically address the interaction with their expanded auditor reporting.[104] The IAASB, FRC, and EU do not have requirements for reporting on ICFR.

Questions:

21. Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?

22. Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?

23. Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?

24. Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?

D. Information About Certain Audit Participants

On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.[105] Firms will be required to file Form AP with the PCAOB for each issuer audit, disclosing this information. In addition to filing Form AP, firms will also have the choice to include this

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[103] *See* paragraph 8 of ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

[104] *See* ISA (UK and Ireland) 570, *Going Concern*, and *see* Article 28, *Audit Reporting*, of Directive 2014/56/EU of the European Parliament and of the Council.

[105] *See* PCAOB Release No. 2015-008 (Dec. 15, 2015).

information in the auditor's report.[106] The reproposed standard incorporates the adopted amendments to AS 3101 for situations in which the auditor decides to include information about certain audit participants in the auditor's report. The reproposed standard would require the auditor to use an appropriate section title when providing this information in the auditor's report, but does not require a specific location in the auditor's report.

Requirements of Other Regulators and Standard Setters

The IAASB requires the auditor to include the name of the engagement partner in the auditor's report for audits of listed entities.[107] Under EU law, the engagement partner is required to sign the audit report in all EU countries, including the United Kingdom.[108] Unlike disclosure of the engagement partner's name, disclosure of other accounting firms that participated in the audit is not required by the IAASB, FRC, or the EU.

E. Form of the Auditor's Report

The proposed standard did not require that the basic elements appear in a specific order in the auditor's report, although as part of the proposal the Board sought comment on whether to require a specific order. The proposed standard only required a title for the "Critical Audit Matters" section, but did not preclude the auditor from including section titles for other sections in the auditor's report.

Some commenters suggested that, to allow for a more effective delivery of key messages and enhance comparability between reports for different companies, the Board should require a specific order of the sections in the auditor's report. Other commenters suggested that there should be flexibility. Some commenters recommended that section titles be required for all sections of the auditor's report.

In response to comments, the reproposed standard would require the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The reproposed standard does

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[106] When the auditor divides responsibility for the audit under AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors*), the auditor's report must acknowledge the involvement of the other auditor.

[107] *See* paragraph 45 of ISA 700.

[108] Directive 2006/43/EC of the European Parliament and of the Council, Article 28, *Audit Reporting* (May 17, 2006).

not specify an order for the remaining sections of the auditor's report, which would include explanatory paragraphs and critical audit matters. This approach allows for consistency in the location of the opinion and basis for opinion sections, with flexibility for the other elements of the auditor's report. The reproposed standard would also require titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report.

Requirements of Other Regulators and Standard Setters

The reproposed approach with respect to the order of the sections of the auditor's report is generally consistent with that of the IAASB.[109] The EU and FRC do not specify an order to the auditor's report.

Question:

25. Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?

V. Amendments to Other PCAOB Standards

The Board is reproposing amendments to several of its existing auditing standards solely to conform to the reproposed standard.[110] The Board is not proposing any further changes to these existing auditing standards at this time, although the Board recognizes that some of the existing auditing standards, such as the standard proposed to be redesignated as AS 3105, may need further updating. The Board may consider proposing further changes to these standards under separate standard-setting projects.

A. Proposed AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

AS 3101.10 and .20-.76 primarily address departures from the auditor's unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion. These paragraphs also address other reporting circumstances, such as

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[109] *See* paragraphs 23–28 of ISA 700.

[110] The reproposed amendments are contained in Appendix 2.

reporting on comparative financial statements. These paragraphs are proposed to be redesignated as AS 3105.[111]

Similar to the 2013 proposal, proposed AS 3105 is not intended to change the circumstances in which the auditor would depart from an unqualified opinion. The changes from the current standard would primarily: (1) require the communication of critical audit matters in certain circumstances; (2) revise certain terminology to align with the reproposed standard; and (3) amend the illustrative reports for the basic elements of the reproposed standard and the required order of certain sections of the auditor's report.

Proposed AS 3105 includes:

1. Communication of Critical Audit Matters in Reports Containing Other than Unqualified Opinions

a. *Qualified opinion*—Similar to the 2013 proposal, proposed AS 3105 would require that when the auditor expresses a qualified opinion, the auditor's report also include communication of critical audit matters, if applicable for the company under audit.

b. *Adverse opinion*—Similar to the 2013 proposal, the existing requirements related to an adverse opinion are not proposed to be amended to require the auditor to communicate critical audit matters because, in such circumstances, the most important matter to investors and other financial statement users would be the reason for the adverse opinion.

c. *Disclaimer of opinion*—Similar to the 2013 proposal, the existing requirements related to a disclaimer of an opinion are not proposed to be amended to require the auditor to communicate critical audit matters because, in such circumstances, the most important matter to investors and other financial statement users would be the reason for the disclaimer of opinion.

2. Considerations in the Auditor's Report Regarding Report by Management on Audit of ICFR

As noted previously, in the 2013 proposal, the Board sought comment regarding requiring an explanatory paragraph in situations in which the company has determined

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[111] AS 3101.01-.09 and .11-.19 would be amended and restated as provided in Appendix 1.

that it is not required to obtain, nor did the company request the auditor to perform, an audit of ICFR. Commenters supported such a requirement.

The Board is proposing to amend AS 3105 to provide the reporting requirements and appropriate language to be added to the auditor's report in such situations.[112]

Requirements of Other Regulators and Standard Setters

Under the IAASB's approach, a matter giving rise to a qualified, adverse, or disclaimer of opinion is by nature a key audit matter.[113] However, in such circumstances (1) the matter should not be described in the key audit matter section of the auditor's report, (2) the auditor should report on the matter in accordance with applicable standards, and (3) the auditor should include a reference in the key audit matter section to the basis for modified opinion section where the matter is reported.[114] The requirements to determine and communicate key audit matters, other than the matters giving rise to the modified opinion, would still apply when the auditor expresses a qualified or adverse opinion, but not when the auditor disclaims an opinion on the financial statements.[115] The FRC and the EU do not include specific requirements for expanded auditor reporting when the auditor's report contains other than an unqualified opinion.

B. Other Amendments to PCAOB Standards

The reproposed amendments to other PCAOB standards are substantially as proposed. These include:

- AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*—amending the example report to conform to the reproposed auditor's report on the financial statements;

- AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*—amending to include the existing reporting

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112 *See* reproposed amendments to AS 3105.59–.60.

113 *See* paragraph 15 of ISA 701.

114 *Id*.

115 *See* paragraph A7 of ISA 701 and paragraph 29 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

requirements and illustrative explanatory language related to a change in accounting principle or a restatement that is currently in AS 3105;

- AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*—amending to require the engagement quality reviewer to evaluate the engagement team's determination, communication, and documentation of critical audit matters;
- AS 1301—amending to require the auditor to provide to and discuss with the audit committee a draft of the auditor's report; and
- AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*)—amending for the basic elements of the reproposed standard.

Commenters generally supported the proposed amendments.

Question:

26. Are the reproposed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?

VI. Economic Considerations

A. Need for the Rulemaking

1. Critical Audit Matters

Investors and other financial statement users know less about a company's financial performance than do others closer to the financial reporting process, particularly management. This information asymmetry[116] can result in situations where capital is allocated suboptimally. The system of financial reporting in the United States, which requires periodic reporting of information, including annual financial statements, helps address the information asymmetry between investors and management. Board of directors and audit committee oversight of the financial reporting process can further reduce this information asymmetry by enhancing the quality of the information disclosed to the public. As part of this system, the audit of the financial statements also helps

[116] Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

Companies' operations continue to become more complex and global. In addition, over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements.[117] These estimates and fair value measurements, which are important to a financial statement user's understanding of the company's financial position and results of operations, can be highly subjective, require significant judgment, and can result in increased measurement uncertainty in financial statements.[118] The increased complexity of financial reporting, including the growing use of complex accounting estimates and fair value measurements may contribute to the information asymmetry between investors and management, despite the fact that management is required to provide significant disclosures to investors and other financial statement users. Investors may find information provided by an independent third party (i.e., the auditor) particularly relevant in this setting.

As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, the auditor's report has not been expanded to provide this information to investors and generally provides only a standardized pass/fail opinion. Because the auditor's report generally does not contain audit-specific information, the auditor knows more about the company and its financial reporting and the challenges of the audit than is reflected in the auditor's report. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the current form of the auditor's report does little to address the information asymmetry between investors and auditors. This may limit the extent to which the auditor's report can address the information asymmetry between investors and management.

Although commenters on the Board's rulemaking have consistently affirmed the usefulness of a pass/fail auditor's opinion, many have also advocated for a more relevant and useful auditor's report that provides additional information from the

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[117] *See* PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014).

[118] *See* IAASB Project Proposal, Revision of ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (Mar. 2016).

auditor's perspective. For example, one commenter argued that an expanded auditor's report "will facilitate better analysis and heighten user confidence in the audited financial statements."[119] The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments should help investors and other financial statement users "consume" the information presented in management's financial statements more effectively. Stated in economic terms, an expanded auditor's report should reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance.

a. Increasing the Informativeness of the Auditor's Report to Address Information Asymmetry

The communication of critical audit matters would inform investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgment, including the principal considerations for determining the matters and how the matters were addressed in the audit. The Board believes that the communication of critical audit matters should help focus investors' and other financial statement users' attention on these matters by making them more prominent, which could facilitate their analysis of the financial statements and other relevant disclosures. The communication of critical audit matters in the auditor's report would also help investors and analysts who were interested in doing so engage management with targeted questions about these issues.[120] While not every critical audit matter would be useful for every investor, broadly, the Board believes that having the auditor provide investors and other financial statements users with additional information about especially challenging, subjective, or complex auditor judgments should help reduce the information asymmetry that exists between investors and management by providing a new perspective on the financial statements.

The communication of critical audit matters may also assist investors in assessing the credibility of the financial statements and, in at least some instances, audit quality.[121] For example, the description of how the auditor addressed the critical

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[119] *See* letter from the CFA Institute (Dec. 30, 2013), at 2.

[120] The FRC observes that, in some instances, investors have begun to use the information provided in the expanded auditor's reports in the U.K. to engage with audit committees. *See* FRC 2016 Report.

[121] An academic study explores the relationship between audit quality and pre-audit financial reporting quality, and notes that, although they are distinct constructs, the two processes are interdependent and jointly determine financial reporting outcomes. *See* Lisa Milici Gaynor, Andrea Seaton Kelton, Molly Mercer, and Teri

audit matter may help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which may allow a more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have stated that having the auditor, a third-party expert, rather than the company provide this type of information would be of added value to investment decision making.[122] Because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility.[123]

Reporting of critical audit matters would add to the mix of information that could be used in investors' capital allocation decisions, for example, by:

- Highlighting the aspects of the financial statement audit that the auditor found to be especially challenging, subjective, or complex;
- Enabling comparison of these aspects of the audit across companies, for example audits of companies within the same industry; and
- Enabling comparison of these aspects of the audit for the same company over time.

b. Mandated Rather than Voluntary Reporting

Auditors have not developed a practice of providing information in the auditor's report beyond what is required, even though investors have consistently requested that the auditor's report become more informative. Current standards provide a framework for auditors to provide limited additional information through emphasis paragraphs,[124] but in general these only point to a disclosure in the company's financial statements without providing any additional description and, as noted below, emphasis paragraphs are infrequent in practice. Auditor reporting about matters significant to the audit is not

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Lombardi Yohn, *Understanding the Relation Between Financial Reporting Quality and Audit Quality*, Auditing: A Journal of Practice and Theory (Forthcoming).

[122] *See* IAG 2011 survey and CFA survey and poll results.

[123] *See, e.g.*, Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* 33 Auditing: A Journal of Practice & Theory 71, 71–93 (2014).

[124] *See* AS 3101.19.

prohibited in an emphasis paragraph, but current standards do not encourage auditors to include such information in their report and do not provide a framework for doing so.

There are many other potential reasons why auditors are not providing information voluntarily in the auditor's report, whether about the financial statements or the audit. Auditors may believe that providing additional information could expose them to potential legal liability[125] or that doing so could be interpreted as a disclaimer of opinion or a partial opinion as to the disclosed matters. Furthermore, the historical model of management disclosing information and the auditor attesting to the information may lead companies to resist voluntary additional reporting by the auditor, either through emphasis paragraphs or with respect to information about the audit, which the auditor would be better positioned to communicate than management. Finally, in general, there may be disincentives to voluntary reporting if the disclosing party is not able to fully capture the benefits of the disclosures,[126] and parties may also exhibit a bias toward the *status quo.*[127] All of these factors disincentivize auditors from voluntarily providing further information about the audit, even if investors and other financial statement users would respond favorably to receiving additional information.

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[125] Section IV.A.4 contains a discussion about potential auditor liability concerns stemming from expanded auditor reporting.

[126] Academic research finds that there are certain situations in which disclosure may be socially optimal but not privately optimal. For example, it is possible that management chooses not to disclose some information that may be useful to investors if that information also benefits a competitor. Auditors and companies may resist voluntary expanded auditor reporting because of similar concerns that these types of spillover effects (or externalities) may create a competitive disadvantage. For a summary of this line of research, *see* Luigi Zingales, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, 394-395 (2009). Professor Zingales is the founding director of the PCAOB's Center for Economic Analysis. The research cited above was published before he joined the PCAOB.

[127] Research in behavioral economics suggests that when facing a set of decisions, individuals are more likely to stick to the known outcome (*status quo*) than would be expected based on the theory of rational decision making under uncertainty. There are a variety of reasons why individuals may choose the status quo outcome in lieu of an unknown outcome, including aversion to the uncertainty inherent in moving from the status quo to another option. *See* William Samuelson and Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 Journal of Risk and Uncertainty 7, 7-59 (1988).

Mandatory disclosure helps promote more complete and consistent disclosure of specified categories of information to all users who may be interested in it.[128] Mandatory disclosure can also improve the allocative efficiency of capital markets by decreasing the costs associated with gathering information, or by providing market participants with information that otherwise would have been difficult or impossible for them to gather.[129]

2. Additional Improvements to the Auditor's Report

The existing auditor's report does not describe important aspects of the auditor's responsibilities under existing auditing standards, such as the auditor's responsibility to detect material misstatements, whether due to error or fraud; the auditor's responsibility for the notes to the financial statements; and the auditor independence requirement. This may contribute to misperceptions by investors and other financial statement users about the auditor's role and responsibilities, including with respect to these matters. Academic research suggests that there are a number of ways in which investor perceptions of the role and responsibilities of the auditor may diverge from what current professional standards require.[130]

In addition, the existing standards do not require a uniform approach to basic content, such as the addressee of the report and the form of the auditor's report. The reproposed standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.

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[128] Academic research on disclosure explores these types of positive externalities, as well as certain negative externalities. *See, e.g*., Ronald A. Dye, *Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities,* 65 The Accounting Review 1, 1-24 (1990); or Anat R. Admati and Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 The Review of Financial Studies 479, 479-519 (2000).

[129] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review 717, 717–753 (1984).

[130] *See, e.g.,* Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008); Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); or Theodore J. Mock, Jean Bedard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing: A Journal of Practice & Theory 323, 323-351 (2013).

The reproposed standard would also require auditors to disclose the number of years they have served as the auditor for the company. Some commenters have indicated that the length of the relationship between the auditor and the company would be a useful data point, and the growing trend toward voluntary disclosure of this information suggests that increasing numbers of companies believe that the market will find the disclosure useful. Further, there is a line of academic research suggesting that there is an association between auditor tenure and increases or decreases in audit quality.[131]

Although investors can determine auditor tenure information using, for example, past auditor's reports, the information is not always readily available to investors.[132] Furthermore, while some issuers voluntarily provide information about auditor tenure in the proxy statement, many do not. Many issuers are also not subject to the proxy rules (for example, investment companies, foreign private issuers and many companies whose securities are not listed on a national securities exchange). In cases where the information is provided voluntarily, it is not provided in a consistent location. Disclosing information about auditor tenure in the auditor's report would provide a consistent location for this information and would reduce search costs, especially for companies that do not voluntarily provide such information or for which the information is not readily available through the EDGAR system.

B. Baseline

The auditor's report in the United States today generally consists of three paragraphs that include limited audit-specific information. The existing auditor's report identifies the company's financial statements that were audited, provides a generic description about the nature of an audit, and provides an opinion on whether the company's financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework. The auditor's report is often described as a pass/fail model because the report only conveys the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail) and typically provides limited information about the nature of the work on which the opinion is based.

The Board's current standards also require that the auditor add explanatory paragraphs to the auditor's report under specific circumstances, such as when there is substantial doubt about the company's ability to continue as a going concern or a restatement of previously issued financial statements. When included, these paragraphs

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[131] *See* Section VI.D.2.e for a discussion of academic research regarding auditor tenure.

[132] *Supra* note 81.

generally consist of standardized language that provides limited audit-specific information.

The auditor may also, at his or her discretion, include emphasis paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Generally, an emphasis paragraph only points to a disclosure in the company's financial statements without providing any additional description. Under current practice, emphasis paragraphs are infrequent.[133] Auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.[134]

Academic research finds that the current form of the auditor's report conveys little of the audit-specific information obtained and evaluated by the auditor.[135] Academic research also finds that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified because it does not provide much additional informational value about a particular audit.[136] The inclusion of explanatory language may provide investors with additional information. A recent academic study suggests that auditor's reports containing certain types of explanatory paragraphs required under existing standards may provide information about the likelihood that financial statements will be subsequently restated.[137] The authors argue that the inclusion of such an explanatory paragraph in the auditor's report can provide a signal to investors about the risk of misstatement of the company's financial statements.

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[133] In the audit reports of approximately 6,350 issuers with fiscal year 2014 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 2 percent of the filings.

[134] *See* AI 20.10*.*

[135] *See* Church et al., *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*.

[136] *See* Gray et al., *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*; Mock et al., *The Audit Reporting Model: Current Research Synthesis and Implications*.

[137] *See* Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increased Financial Misstatement Risk?* 89 The Accounting Review 2115, 2115–2149 (2014).

The existing auditor's report is not required to have a specified addressee but it may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[138] Under current practice, the auditor's report is generally addressed to one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[139]

The current auditor's report also includes the report title, the date, and the name and location of the accounting firm's office issuing the report. Currently, the title of the auditor's report, "Report of Independent Registered Public Accounting Firm," provides the only indication of the auditor's independence. The auditor is not currently required to disclose in the auditor's report the number of years it has served as auditor for the company. However, as noted earlier, some companies have begun voluntarily disclosing auditor tenure in the proxy statement.

C. Benefits

1. Critical Audit Matters

Economic theory commonly attributes two benefits to mandatory disclosure. First, the disclosure of previously unknown value-relevant information directly benefits the market because it allows market participants to make better-informed decisions. Second, the disclosure of such information may indirectly benefit the market because some parties may change their behavior in positive ways after information is disclosed.

a. Direct Benefit: More Informative and Useful Auditor's Report

The Board believes that auditor communication of critical audit matters should reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. For example:

- *Informing*: Identification of the matters arising from the audit that the auditor considered especially challenging, subjective, and complex, together with a description of how the audit addressed those matters,

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[138] *See* AS 3101.09.

[139] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers, benefit plans, and brokers and dealers.

which could provide valuable information about, for example, the company's business environment or financial reporting choices;

- *Framing*: Critical audit matters could provide investors with a new perspective on the financial statements and focus their attention on the related financial statement accounts and disclosures, which could facilitate their analysis of the financial statements, and help them assess financial performance, for example, by reducing the costs to process or search for the information; and

- *Monitoring*: The ability to identify and evaluate the matters identified as critical audit matters may also help investors and analysts engage management with targeted questions about these issues and support investor decisions on ratification of the auditor.

Some commenters stated that the communication of critical audit matters would focus users' attention on issues that would be pertinent to understanding the financial statements for purposes of investment decisions or financial analysis. For example, long-term investors, such as asset or pension plan managers that maintain their own analytical models, commented that critical audit matters would be of value to them in identifying areas specific to each company that may require further analysis or discussion with management in order to be properly understood and reflected in analyst models. One commenter also said that additional insights on how a firm has addressed critical audit matters could bear on investors' decisions on ratifying the audit committee's choice of external auditor.

The communication of critical audit matters aims to provide investors and financial statement users with specific information about the audit of a company's financial statements. Some commenters were concerned, however, that the communication of critical audit matters could lead to a reduction in comparability of auditor's reports. Their concerns related primarily to how investors and other financial statement users may interpret differences in critical audit matters between the company's current period and prior periods, or between the company and its competitors. Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, to the extent the information provided is useful in evaluating financial performance, highlighting these differences should be informative. Further, some commenters said that investors are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditor's reports across companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or MD&A that is specific to a company or a reporting period.

A body of academic research regarding the possible effects of expanded auditor reporting is emerging.[140] The Board is monitoring this research with a view towards assessing its potential relevance to the Board's consideration of the reproposal. The Board is mindful, however, of several issues that limit the extent to which this research can inform its decision making. Much of this research is unpublished and at a relatively early stage; the current conclusions may be subject to multiple interpretations and it is possible that results from this research may be revised during the peer review process. Moreover, it may be difficult to generalize results outside the context of specific studies. For example, in considering the implications of academic studies based on data from other jurisdictions, differences between the Board's reproposed rule and the requirements in other jurisdictions must be taken into account. In addition, specific characteristics of the U.S.-issuer audit market may make it difficult to generalize observations made in other markets because of differences in baseline conditions (for example, market efficiency, affected parties, policy choices, legal environment, and regulatory oversight). As to experimental research in particular, it should be noted that the experimental setting may not provide study participants with information that is representative of the information environment in which market participants actually operate; for instance, if new information appeared more salient to study participants than it would to a market participant, the impact of expanded auditor reporting would be overstated in an experimental setting.

One experimental study conducted prior to the 2013 proposal concluded that nonprofessional investors who were provided with an auditor's report with a paragraph similar to a critical audit matter paragraph were more likely to change their investment decision relative to nonprofessional investors who were provided with (1) a standard auditor's report and standard financial statement disclosures or (2) a standard auditor's report and information in the financial statement disclosures that would have been included in a critical audit matter paragraph.[141] Two unpublished academic studies have

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[140] For a review of relevant academic research, *see* Jean Bédard, Paul Coram, Reza Espahbodi, and Theodore J. Mock, *Does Recent Academic Research Support Changes to Audit Reporting Standards?* Accounting Horizons (Forthcoming).

[141] *See* Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* This study was conducted prior to the PCAOB's 2013 proposal but was published subsequent to it. Although the authors' findings suggest that there is informational value in critical audit matters provided by the auditor, it is unclear whether other potentially relevant results identified in the paper were affected by certain assumptions, such as negative assurance or a separate opinion related to the matters identified as critical audit matters.

also found that the inclusion of critical audit matters in the auditor's report may have an informational effect on investment decision making.[142]

While these studies analyze potential effects of expanded auditor reporting on the perception of financial reporting quality, at least one study analyzes how the IAASB's expanded auditor's report influenced perceptions of audit quality.[143] The authors did not find evidence that key audit matters had an effect on the participants' perception of audit quality.

Several unpublished studies have analyzed how investors reacted to the implementation of expanded auditor reporting in other jurisdictions. One study did not find a financial market reaction to expanded auditor reporting in France, where a form of such reporting has been required since 2003.[144] Other studies have analyzed data from the United Kingdom. Lennox et al. found that expanded auditor reporting did reliably reflect the financial reporting risks of companies listed on the London Stock Exchange,

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[142] One study found that critical audit matters in the auditor's report regarding management's estimates are value-relevant to users' investment decisions. *See* Marcus Doxey, *The Effects of Auditor Disclosures Regarding Management Estimates on Financial Statement Users' Perceptions and Investments* (June 2014) (working paper, available in Social Science Research Network ("SSRN")). The second study concluded that additional reporting in the auditor's report can increase investors' attention to financial statement disclosures mentioned in the auditor's report, but that the communication of critical audit matters led to a decrease in the perceived level of audit quality and a perception that the level of assurance provided by the audit was not uniformly applicable across all aspects of the financial statements. *See* Louis–Philippe Sirois, Jean Bédard, and Palash Bera, *The Informational Value of Key Audit Matters in the Auditor's Report: Evidence from an Eye–Tracking Study (*Dec. 2015) (working paper, available in SSRN).

[143] *See* Pran Krishansing Boolaky and Reiner Quick, *Bank Directors' Perceptions of Expanded Auditor's Report*, International Journal of Auditing (Forthcoming).

[144] The study did not find evidence that the information provided in the expanded auditors' reports was associated with a significant change in cumulative abnormal returns measured during an event window around the filing of the auditor's report. *See* Jean Bédard, Nathalie Gonthier–Besacier, and Alain Schatt, *Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience* (Jan. 2014) (working paper, available in Docket 034).

but did not result in an improvement to the information available to investors.[145] Gutierrez et al. analyzed market prices and trading volume, but did not find evidence that investors reacted to the implementation of expanded auditor reporting in the United Kingdom.[146] However, Reid et al. found a significant increase in trading volume particularly for companies about which there is less information available to investors as measured by lower analyst coverage.[147] Although there could be other explanations for the increase in trading volume, the authors argue that, "as the information environment weakens (i.e., analyst following decreases), there is a greater increase in the usefulness of the reports as a result of the additional auditor and audit committee disclosures."[148] That the documented increase in trading volume was particularly salient for less-followed companies may have important implications for the Board's proposed rule because, if adopted, it would apply to a wider range of U.S. public companies than does the FRC's rule, which applies only to companies with a premium listing on the London Stock Exchange. However, it should be noted that the FRC implemented rules requiring both the auditor and the audit committee to disclose additional information in their respective reports. As the auditor's report is issued concurrently with the audit committee's report, it is difficult to separately identify the effects of the two reforms.

Overall, the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements. The Board will continue to monitor academic research in this area during the rulemaking process.

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[145] The authors concluded that investors were already able to assess the financial reporting risks prior to the auditor's communication. *See* Clive S. Lennox, Jaime J. Schmidt, and Anne Thompson, *Is the Expanded Model of Audit Reporting Informative to Investors? Evidence from the UK* (June 2015) (working paper, available in SSRN).

[146] *See* Elizabeth Gutierrez, Miguel Minutti–Meza, Kay Tatum, and Maria Vulcheva, *Consequences of Changing the Auditor's Report: Evidence from the U.K*. (Mar. 2016) (working paper, available in SSRN).

[147] The authors argued that the additional information provided in the expanded format of the auditor's report was useful to investors. *See* Lauren C. Reid, Joseph V. Carcello, Chan Li, and Terry L. Neal, *Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom* (July 2015) (working paper, available in SSRN).

[148] *Id.* at 25.

b. Indirect Benefit: Improved Audit and Financial Reporting Quality

In general, information asymmetry can lead to situations in which an agent (such as an auditor) takes actions that do not coincide with the best interests of the principal (such as an investor), if the agent's incentives are misaligned.[149] This type of problem is the result of the inability of the principal to understand or monitor the agent's behavior, which also inhibits the principal's ability to identify and reward optimal behavior. Economic theory posits that the disclosure of information can have indirect effects that lead to changes in behavior.[150] Academic research suggests that "any additional information about the agent's action, however imperfect, can be used to improve the welfare of both the principal and the agent."[151]

In the context of the audit, providing investors and other financial statement users with information about the audit through the communication of critical audit matters may provide auditors, management, and audit committees with additional incentives to change their respective behavior in ways that may enhance audit quality and ultimately financial reporting quality. For instance, the communication of critical audit matters may lead:

- Auditors to focus more closely on the matters identified as critical audit matters;

- Management to improve the quality of their disclosures because they would know that investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters; and

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[149] Economists use principal-agent theory to analyze situations where one party (the principal) hires another party (the agent) to perform certain tasks and decision-making ability is delegated to the agent. For a general discussion of principal-agent theory, *see, e.g.*, Michael C. Jensen and William H. Meckling. *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics 305, 305-360 (1976), or Bengt Holmstrom, *Moral Hazard and Observability*, 10 The Bell Journal of Economics 74, 74-91 (1979).

[150] *See, e.g.*, George Loewenstein, Cass R. Sunstein, and Russell Golman, *Disclosure: Psychology Changes Everything*, 6 Annual Review of Economics 391, 391-419 (2014).

[151] Holmstrom, *Moral Hazard and Observability*, at 75.

- Audit committees to focus on the matters identified as critical audit matters and to engage management about the adequacy of the related disclosures.

The communication of critical audit matters may lead auditors to increase their focus on the matters identified in the auditor's report as critical audit matters. As suggested by commenters, the communication of critical audit matters may further incentivize auditors to demonstrate the level of professional skepticism necessary for high quality audits in the areas of the critical audit matters. In addition, auditors may feel that the potentially heightened scrutiny of the matters identified as critical audit matters may warrant additional effort to satisfy themselves that they have obtained an appropriate amount of audit evidence to support their opinion.

The communication of critical audit matters may also heighten management's attention to the relevant areas of financial statements and related disclosures. Some commenters said that communication of critical audit matters may serve as an incentive for management to provide better disclosure or adopt more widely accepted financial reporting approaches in these areas. This may be especially true if the communication of critical audit matters prompts analysts and others to engage management about the related financial statement accounts and disclosures. Increased management attention on the related aspects of the financial statements described in the critical audit matters in response may lead to an incremental increase in the quality of information presented in the financial statements and related disclosures. Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.[152]

In addition, the communication of critical audit matters may help focus the audit committee's oversight efforts by providing information allowing the audit committee to engage more effectively with the auditor and management about the matters identified as critical audit matters and the adequacy of the company's related disclosures.

To the extent these changes in behavior occur, they may lead to an incremental increase in audit quality and financial reporting quality, which could increase investors' confidence in the reliability of the financial statements. Some commenters stated that a more transparent and informative auditor's report could heighten user confidence in the

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[152] *See, e.g.*, Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2012). Professor Leuz is an economic advisor at the PCAOB. The research cited above was published before he joined the PCAOB.

audit and the audited financial statements. Ultimately, an increase in investor confidence could decrease the average cost of capital.[153]

One academic study analyzed whether expanded auditor reporting in France lead to increased audit quality.[154] The authors did not find evidence that a proxy for audit quality was affected by the introduction of expanded auditor reporting. In addition, two unpublished studies conducted using data from the United Kingdom analyze whether audit quality improved after the implementation of expanded auditor and audit committee reporting. Gutierrez et al. did not find evidence that the absolute value of discretionary accruals changed following the implementation of expanded auditor and audit committee reporting in the United Kingdom, and therefore concluded that the new reports did not have an impact on audit quality.[155] However, Reid et al. found that expanded auditor and audit committee reporting is associated with several commonly used proxies for audit quality.[156] The authors of the study noted that it is difficult to disentangle the effects of the two reports, however their analysis suggests an increase in audit quality following the introduction of the expanded auditor's report in conjunction with the expanded audit committee report.

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[153] *See* Luigi Guiso, Paola Sapienza, and Luigi Zingales, *Trusting the Stock Market*, 63 The Journal of Finance 2557, 2557–2600 (2008). Professor Zingales is the Founding Director of the PCAOB's Center for Economic Analysis. The research cited here was published before he joined the PCAOB.

[154] *See* Bédard et al., *Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience*.

[155] *See* Gutierrez et al., *Consequences of Changing the Auditor's Report: Evidence from the U.K*.

[156] Specifically, the authors of this study found that abnormal accruals and the propensity to meet or beat analysts' earnings expectations declined for companies that implemented the new reporting regime. Because the authors observed an increase in proxies for audit quality, but did not observe an associated increase in audit fees or financial reporting delays, the authors argued that the increase in audit quality may have been driven by an incremental increase in the leverage that auditors and audit committees have over management stemming from the enhanced audit reporting requirements. *See* Lauren C. Reid, Joseph V. Carcello, Chan Li, and Terry L. Neal, *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom* (Aug. 2015) (working paper available in SSRN).

c. Indirect Benefit: Differentiation Among Auditor's Reports

If investors and other financial statement users perceive and respond to differences in the quality and usefulness of the information communicated by auditors regarding critical audit matters, expanded auditor reporting may serve as a potential means of greater differentiation among accounting firms and engagement partners.[157]

In the United Kingdom, there is evidence that some investors recognize the progress that auditors are making to improve transparency in their auditor's reports through their implementation of the FRC reporting requirements. The FRC notes that investors greatly value the information provided in expanded auditor reporting.[158] For example, in the two years following the implementation of these requirements, an association of investment managers has recognized in an annual awards ceremony those specific auditor's reports found to be most clear and most innovative in providing insight into the audit of the company's financial statements.[159] In addition, the FRC notes that users of the new auditor's reports identified certain descriptions of risks that they found to be more useful—such as descriptions which are specific to the entity being audited. Further, the FRC report notes that, in the second year of implementation, a much greater proportion of risks were set out in a more meaningful and transparent way.[160]

The FRC report also noted that there are clear differences among accounting firms in the approaches taken to implement the requirements. For example, one firm went beyond the FRC's requirements by including audit findings for the risks of material misstatement in the majority of its auditor's reports in the second year of implementation, which other firms did far less frequently. The FRC's observations may suggest that accounting firms took different approaches to the requirement and could distinguish themselves based on the quality and usefulness of the information provided in the expanded auditor's reports. Motivated in part by differences in the approaches used by accounting firms in the United Kingdom, an academic study analyzed whether investors responded differently to the auditor's reports issued by certain accounting

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[157] The Board has adopted final rules that, assuming final approval by the SEC, will require identification of the engagement partner on issuer audits on a new PCAOB form. *See* PCAOB Release No. 2015-008 (Dec. 15, 2015).

[158] *See* FRC 2016 Report.

[159] *See* the FRC's *Extended Auditor's Reports, A Review of Experience in the First Year* (Mar. 2015); and FRC 2016 Report.

[160] *Id.*

firms.[161] The authors of the study found that the auditor's reports issued by certain accounting firms were associated with larger differences in abnormal trading volume. The authors argued that the results suggested that investors found the auditor's reports issued by some accounting firms to be more useful than others.

In addition to relying on the audit committee (which, at least for listed companies, is charged with overseeing the external auditor), in the absence of differentiation based on the auditor's report, users of financial statements may rely on proxies such as the reputation of the accounting firm issuing the auditor's report, aggregated measures of auditor expertise (for example, dollar value of issuer market capitalization audited or audit fees charged), or information about the geographic location of the office where the auditor's report was signed as signals for audit quality. Academic research finds, however, that these are imperfect signals of audit quality.[162]

The identification and description of critical audit matters could permit differentiation among auditor's reports based on investor perceptions of their informativeness and usefulness. In some instances it may also provide a signal of audit quality. Because the determination of critical audit matters may reflect a variety of considerations, however, critical audit matters may not bear directly on audit quality. For example, the choice of which critical audit matters to communicate or how to describe them may reflect considerations such as the company's business environment and financial reporting choices, accounting firm methodology, engagement partner characteristics, and legal advice. Thus, a robust description of critical audit matters may not necessarily reflect a higher quality audit than a less detailed description of such matters.

Nevertheless, informative descriptions of how the audit addressed critical audit matters could provide insight into the extent and appropriateness of the auditor's work. Moreover, it is possible that thoughtful, audit-specific and useful critical audit matters (or, conversely, generic and uninformative critical audit matters) could affect investor perceptions of the auditor's work and willingness to provide useful information. As a result, the communication of critical audit matters, potentially in conjunction with disclosures regarding the identity of the engagement partner and other accounting firms

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[161] *See* Reid et al., *Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom*.

[162] *See, e.g.*, J.R. Francis, *A Framework for Understanding and Researching Audit Quality*, 30 Auditing: A Journal of Practice & Theory 125, 125–152 (2011) and Mark DeFond and Jieying Zhang, *A Review of Archival Auditing Research*, 58 Journal of Accounting and Economics 275, 275–326 (2014).

that participated in the audit,[163] and other relevant information could enable differentiation among auditors on that basis.

2. Additional Improvements to the Auditor's Report

The reproposed standard contains other changes to the auditor's report intended to improve and clarify the language for certain elements, such as statements related to the auditor's responsibilities regarding the notes to the financial statements, and promote a uniform presentation of this information across auditor's reports. Additionally, the reproposed standard would introduce new requirements regarding the addressee of the auditor's report and statements in the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for reporting on ICFR.[164]

The statement regarding the auditor's existing obligation to be independent of the company is intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations. By requiring the auditor's report to be addressed to certain parties, the Board would be promoting uniformity in the addressees of the auditor's report.

Disclosing information about auditor tenure in the auditor's report would provide a consistent location for this information and decrease the search costs for investors and other financial statement users who are interested in this piece of information.[165] The disclosed information could also prompt investors and other financial statement users to engage management, and ultimately the audit committee, about issues related to auditor tenure.

For most of these changes to the auditor's report, commenters on the 2013 proposal generally agreed that the proposed changes would enhance the description in the auditor's report of the auditor's responsibilities under existing auditing standards and would facilitate comparisons between auditor's reports for different companies. Commenters' views were mixed with respect to the statement regarding auditor tenure.

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[163] *See* PCAOB Release No. 2015-008.

[164] In circumstances where management is required to report on ICFR but the auditor is not and has not performed an audit of ICFR, the reproposal would require a statement to that effect in the auditor's report.

[165] *See* Section VI.D.2.e for a discussion of academic research regarding auditor tenure.

D. Costs and Potential Unintended Consequences

1. Costs

Commenters on the 2013 proposal generally did not quantify the cost to implement the proposal. Several commenters indicated that at this point it is hard to quantify the costs that would be incurred to implement the proposal. Even those that conducted limited implementation testing of the proposal were unable to provide a quantified cost estimate. Therefore, based on the comments and the lack of data, the Board is unable to quantify costs, but provides a qualitative cost analysis.

As an additional means of assessing potential cost implications of the reproposed standard, PCAOB staff has reviewed data from the first year of implementation of expanded auditor reporting in the United Kingdom.[166] As discussed below, staff analyzed a variety of data points that may be associated with potential costs, including audit fees, days required to issue the auditor's report and the content of the expanded auditor's report. It should be noted that it may be difficult to generalize observations from the UK experience. For example, the reporting and documentation requirements relating to expanded auditor’s reports in the United Kingdom differ from those in the reproposal, the baseline legal environments are different, and the UK requirements apply only to companies with a premium listing on the London Stock Exchange and not, for example, to smaller companies that list on London's AIM market.

a. Critical Audit Matters

Based on comments to date, the Board anticipates that the reproposed requirement regarding critical audit matters would have potential cost implications for auditors and companies, including their audit committees. Such costs would primarily relate to additional time to prepare and review auditor's reports, including high-level discussions with management and audit committees as well as legal costs for review of the information provided in the critical audit matters. In addition, even though no performance standards are being amended, as discussed earlier in this release, auditors may choose to perform more audit procedures related to areas reported as critical audit matters, with cost implications for both the auditor and management.

For auditors, costs might represent both one-time costs and recurring costs. One-time costs could be incurred as a result of: (1) updating accounting firm audit and quality control methodologies to reflect the new reporting requirements and (2)

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[166] *See White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700*, available on the Board's website in Docket 034.

developing and conducting training of accounting firm personnel on the new reporting requirements. When updating methodologies, some accounting firms would likely also develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters.

Recurring costs would primarily reflect additional effort expended in individual audits. The reproposed standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which would be based on work the auditor has already performed. However, there would be some additional recurring costs associated with drafting descriptions of critical audit matters and related documentation. It is likely that senior members of the engagement teams, such as partners and senior managers, would be involved in determining the critical audit matters and developing the language to be included in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office, would also result in recurring costs. Additional time might also be incurred by the auditor as a result of discussions with management or the audit committee regarding critical audit matters.

Companies, including audit committees, could also incur both one-time and recurring costs as a result of the reproposed standard. One-time costs could be incurred, for example, in educating audit committee members about the requirements of the new standard and in developing management and audit committee processes for the review of draft descriptions of critical audit matters and the related interaction with auditors. Recurring costs would include the costs associated with carrying out those processes, as well as any increase in audit fees associated with the new reporting requirements or legal fees stemming from a review of critical audit matter communications.

If the drafting and review of critical audit matter reporting takes place towards the end of the audit, there may also be an opportunity cost associated with the time constraints on the parties involved (including, for example, management, the engagement partner, the audit committee, and the auditor's and company's respective legal counsel). The end of the audit is a busy period in which multiple issues may need to be resolved before the auditor's report can be issued. At the same time, companies and management would also be in the process of preparing the annual report. Time spent drafting and reviewing the communication of critical audit matters could occur at the same time as other important work in the financial reporting and audit process, and would involve management that command high annual salaries or auditors and lawyers with high hourly billing rates. In addition, the communication of critical audit matters could lead to changes in management's disclosures, which may result in a longer and more expensive financial reporting process.

Commenters' views varied significantly about the likely magnitude of direct costs associated with auditor reporting of critical audit matters. Some commenters said that there would not be material additional costs for communication of critical audit matters, as these matters would already have been reviewed by the engagement quality reviewer, documented in the engagement completion memo, and communicated to the audit committee. This may suggest that a substantial amount of the work required to communicate critical audit matters would already have been completed earlier in the audit. On the other hand, some companies said that critical audit matters would result in substantial additional costs for auditors and companies. One commenter surveyed accounting executives of 63 publicly-traded manufacturing companies; one-third believed that audit fees would rise by 6 to 10 percent, while another third said that fees could rise by more than 10 percent. Several companies stated that, in their view, the total costs associated with critical audit matters outweigh the perceived benefits that investors may get from the information provided. Other commenters stated that while audit fees would increase as a result of the communication of critical audit matters, investors would support additional fees for additional useful qualitative information.

In its review of the implementation of expanded auditor reporting in the United Kingdom, the PCAOB staff did not find evidence of statistically significant increases in audit fees following the first year of expanded auditor reporting.[167] The median fee change was zero and for the majority of companies, audit fees for the year of implementation remained the same or decreased as compared to the prior year's audit fees. Audit fees increased for the remaining companies. The PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent.[168] It should be noted that the PCAOB staff's review did not analyze whether other factors, such as inflation, corporate acquisitions, or the implementation of other regulatory changes, contributed to the documented increase in audit fees, or whether audit firm profitability was affected. Also, audit fees would not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms chose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting.

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[167] *Id.*

[168] Academic research also finds an approximately 4 percent increase in audit fees two years after the implementation of expanded auditor's reporting in the United Kingdom. *See* Gutierrez et al., *Consequences of Changing the Auditor's Report: Evidence from the U.K.* The authors of another unpublished academic study that examined only the first year of implementation also found that audit fees increased marginally. They argued that the increase was likely due to the continuation of an upward trend in fees that was unaffected by the new reporting requirements, although they were unable to conclusively state that the enhanced audit reporting requirements had no effect on audit fees. *See* Reid et al., *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom*.

b. Additional Improvements to the Auditor's Report

The reproposed changes to the basic elements of the auditor's report do not represent a significant departure from the 2013 proposal. Some of the enhanced basic elements would have cost implications for auditors. One-time costs would primarily relate to updating methodology and training and the initial determination of the first year the auditor began serving consecutively as the company's auditor. Based on comments received, it does not appear that the reproposed changes to the basic elements would impose significant recurring costs, because they involve standardized language that, once implemented, would be the same or very similar across different auditor's reports every year.

2. *Potential Unintended Consequences*

a. Time Needed to Issue the Auditor's Report

As a result of the additional effort required to determine, communicate, and document critical audit matters, some commenters said that it would take auditors longer to issue their reports. Other commenters were concerned that the quality of the audit may be negatively affected if auditor's reports, including critical audit matters, were issued within the current timeframe.

The PCAOB staff study did not find evidence that compliance with the United Kingdom's recently implemented expanded auditor reporting requirements delayed the issuance of auditor's reports in the first year of implementation. Based on the study, for companies that had three years of financial statements, a new form auditor's report was issued, on average, in 63 days from the company's fiscal year end date in the year of implementation, as compared to 64 days in the prior year and 65 days two years earlier. Academic research conducted using data from the United Kingdom also did not find evidence that the new reporting requirements led to delays in financial reporting.[169]

b. Number and Content of Critical Audit Matters

Some commenters indicated an expectation that the auditor's report would include a long list of critical audit matters. They said that this would occur because the auditor would be motivated to communicate as much as possible in an effort to mitigate any future liability for unidentified critical audit matters. In their view, such a development could make the report more difficult to navigate and less useful and may result in duplicative communications if the auditor provides information already

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[169] *See* Reid et al., *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom*.

disclosed by management. Other commenters indicated that expanded auditor reporting could lead to a checklist approach, which could result in standardized language and diminish the expected value of the critical audit matters.[170] At the same time, other commenters thought that, at least for certain types of issuers, the auditor may not identify any critical audit matters to communicate in the auditor's report. If auditors choose to provide only generic information about the audit, the communication of critical audit matters would not decrease information asymmetry about the audit, and may obscure other important information included in the auditor's report and the audited financial statements.

The reproposed requirements aim to provide investors with the auditor's unique perspective on the areas of the audit that involved the auditor’s especially challenging, subjective, or complex judgments. Focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. Further, limiting critical audit matters to these areas should mitigate the extent to which expanded auditor reporting could become standardized.

The PCAOB staff study did not find evidence that expanded auditor reporting in the United Kingdom resulted in a very large number of risk topics or none at all in the first year of implementation.[171] On average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight. Additionally, the descriptions of the risks of material misstatement in the auditor's reports in the first year of implementation were not presented in standardized language, but included variations in content length, description, and presentation. The most frequently described risk topics related to revenue recognition, tax, and goodwill and intangible assets. The FRC report finds a similar range and average number of risk topics disclosed in both the first and second year of the implementation of expanded auditor reporting in the United Kingdom.[172] The FRC report also finds disclosure of similar risk topics in the second year of implementation of

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[170] These commenters generally suggested that the auditor provide the "principal" or "primary" considerations, but not all considerations, that led the auditor to determine that the matter is a critical audit matter. The reproposed requirement for critical audit matters incorporates this suggestion.

[171] *See White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700*, available on the Board's website in Docket 034.

[172] *See* FRC 2016 Report.

expanded auditor reporting in the United Kingdom.[173]

Further, the FRC found that, in the second year of expanded auditor reporting in the United Kingdom, the discussion of risks has improved relative to the first year of implementation and that the majority of auditor's reports provided discussion of significant risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.[174] These findings suggest that, thus far, the expanded UK auditor reporting has not become standardized in the United Kingdom.

As described earlier, academic research conducted in other jurisdictions has had inconclusive findings so far regarding the usefulness of information provided in expanded auditor reporting. Although some papers found that the communications may be predictable or redundant,[175] there is some evidence of abnormal trading volume stemming from the disclosed information.[176] However, results from experimental research on the communication of critical audit matters suggested that investors do read and value the communication in the auditor's report, even if management made similar disclosures in the financial statements.[177]

c. Effects of Increased Attention to Critical Audit Matters

The communication of critical audit matters could lead auditors, company management, and the audit committee to spend additional time and resources on reviewing the adequacy of the work performed on the related financial statement accounts and disclosures. While this could lead to an incremental improvement in audit and financial reporting quality for the identified critical audit matters, it is also possible that there may be increased costs for auditors as a result of the reproposed requirements. For example, even though the communication of critical audit matters does not mandate the performance of additional audit procedures, it is possible that

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173 *Id.*

174 *Id*.

175 *See* Lennox et al., *Is the Expanded Model of Audit Reporting Informative to Investors? Evidence from the UK*, or Bédard et al., *Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience*.

176 *See* Reid et al., *Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom*.

177 *See* Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

some auditors may perform additional procedures. If that occurs, the associated costs may be passed on—in whole, in part, or not at all—to companies and their investors in the form of higher audit fees. Further, increased procedures may also require additional time from the company's management to deal with such procedures. In addition to increased costs, the increased attention on certain matters could also lead to a related decrease in audit and financial reporting quality of other material aspects of the financial statements and disclosures if they receive less attention.

The communication of critical audit matters could also lead to changes in auditor incentives and behavior that negatively affect audit quality. For example, an unpublished academic study suggests that changes in auditor incentives could cause audit quality to decrease under certain circumstances.[178] However, some commenters suggested that such changes in incentives could improve auditor skepticism and audit quality.

Some commenters indicated that including critical audit matters in the auditor's report could also inhibit communication among the auditor, management, and the audit committee because of concerns about what would be publicly communicated in the auditor's report. A recent academic paper also explored this possibility and found in an experimental study that participants acting as management chose to share less private information about key accounting estimates in a regime in which their auditors were able to disclose information about management's estimates as a critical audit matter.[179]

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[178] This study developed a theoretical model to analyze how expanded auditor reporting affects auditor effort, audit quality, and investment decisions. In the model, investors use signals of audit quality provided by expanded auditor reporting as a means to assess the likelihood that they could recover damages from the auditor in the event of an audit failure. The authors of the study found that while expanded auditor reporting enhances the decision usefulness of financial reports for investors, it can also adversely affect the auditor's incentives and consequently lower the expected level of audit quality if the underlying level of financial reporting quality is high and investors only use the auditor's report to verify the auditor's pass/fail opinion about the presentation of the financial statements. The authors concluded by noting that arguments in favor of disclosing critical audit matters are weakened if the underlying level of financial reporting quality is high. *See* Qi Chen, Xu Jiang, and Yun Zhang, *Does Audit Transparency Improve Audit Quality and Investment Efficiency?* (Dec. 2014) (working paper, available in SSRN).

[179] The authors argued that managers who sense that they are losing control over the company's disclosures will choose to disclose less information to the auditor in an effort to limit any negative investor reaction to auditor reporting. *See* Nicole Cade and Frank D. Hodge, *The Effect of Expanding the Audit Report on Managers' Communication Openness* (Aug. 2014) (working paper, available in SSRN).

PCAOB standards require the auditor to communicate to the audit committee information about management's estimates, among other matters.[180] Additionally, although management may have an increased incentive to withhold information from the auditor when the auditor is required to communicate critical audit matters, if management actually chose to provide the auditor with less information than requested, under the Board's existing standards[181] the auditor may determine that there is a scope limitation and qualify the auditor's opinion. Under the reproposed standard, critical audit matters are determined from the matters communicated or required to be communicated to the audit committee. With respect to any matters required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. It would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee, although, as described above, there should be few communications affected by that possibility.

Although the communication of critical audit matters may lead to changes in the incentives for the auditor, company management, and the audit committee to communicate with each other, initial anecdotal evidence suggests that the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications.

d. Changes in Perceived Assurance on the Auditor's Report, Including Perceptions of Auditor Liability

The communication of critical audit matters could have liability implications for auditors. For a more detailed discussion of liability, *see* Section IV.A.4. In addition, because the communication of critical audit matters requires auditors to discuss aspects of the audit that they found to be especially challenging, subjective, or complex, it is possible that some investors and financial statement users may misconstrue the communications to mean that auditors were unable to obtain reasonable assurance about the matters identified as critical audit matters. Some commenters have said that the communication of critical audit matters could lead to changes in the way investors and financial statements users perceive the level of assurance provided by the audit on matters identified as critical audit matters. This could result in a situation in which investors believe that auditors are providing separate assurance about the presentation

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180 AS 1301.12(c).

181 *See* AS 3101.20-.26.

of the financial statements and may have implications for perceptions of auditor responsibility in the event of an audit failure.[182]

Several academic papers analyze certain risks associated with communicating critical audit matters, including perceptions of auditor responsibility.[183] Each paper relies on an experiment in which participants were presented with information about financial statement misstatements and critical audit matters. Researchers evaluated the impact of expanded auditor reporting on participants' perceptions of auditor responsibility. The results of these studies vary and are sometimes contradictory.[184] While some papers suggest that expanded auditor disclosure could result in a perception of decreased

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[182] Academic research on financial statement users' perceptions of critical audit matters suggests that these unintended consequences may be possible. *See* Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* or Marcus Doxey, *The Effects of Auditor Disclosures Regarding Management Estimates on Financial Statement Users' Perceptions and Investments*.

[183] *See* Tim Brown, Tracie M. Majors, and Mark. E. Peecher, *The Impact of a Judgment Rule and Critical Audit Matters on Assessments of Auditor Legal Liability—The Moderating Role of Legal Knowledge* (Dec. 2014) (working paper, available in SSRN); Kelsey R. Brasel, Marcus M. Doxey, Jonathan H. Grenier, and Andrew Reffett, *Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability*, The Accounting Review (Forthcoming); Ann G. Backof, Kendall Bowlin, and Brian M. Goodson, *The Impact of Proposed Changes to the Content of the Audit Report on Jurors' Assessments of Auditor Negligence* (Feb. 2016) (working paper, available in SSRN); Christine Gimbar, Thomas Bowe Hansen, and Michael E. Ozlanski, *The Effects of Critical Audit Matter Paragraphs and Accounting Standard Precision on Auditor Liability: Can Anything the Auditor Says Be Used Against Them?* The Accounting Review (Forthcoming); and Steven J. Kachelmeier, Jaime J. Schmidt, and Kristen Valentine, *The Disclaimer Effect of Disclosing Critical Audit Matters in the Auditor's Report* (Dec. 2015) (working paper, available in SSRN).

[184] For a more detailed description of the methodologies and results of several of the above-referenced studies, see Christine Gimbar, Bowe Hansen, and Michael E. Ozlanski, *Early Evidence on the Effects of Critical Audit Matters on Auditor Liability*, 10 Current Issues in Auditing A24, A24-A33 (2016).

auditor responsibility,[185] other papers suggest the opposite effect.[186] Most of the studies acknowledge that findings may depend on the design of the experiment, the particular hypotheses being tested, the specific facts and circumstances presented to the experiment participants, and the background of the participants themselves.

Therefore, while this type of research can have important implications for how critical audit matters are viewed in relation to the overall level of assurance provided by an audit, it is difficult to draw generalizable conclusions based solely on these papers. If the communication of critical audit matters were to lead to a reduction in perceived auditor responsibility, as is suggested by some of the working papers, and this in turn reduced auditor liability, it is possible that auditors may feel that less audit work is needed on the matters identified as critical audit matters. This could lead to a decrease in audit quality. The Board will continue to monitor emerging research related to expanded auditor reporting in the U.S., as well as research in other jurisdictions in which such reporting is already occurring.

On the point of whether the communication of critical audit matters could result in the perception of separate assurance, the reproposed standard would require the following statement in the auditor's report that "Critical audit matters do not alter in any way [the auditor's] opinion on the financial statements, taken as a whole, and [the auditor does not] provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate." The purpose of this statement is to make clear that the communication of critical audit matters in an auditor's report should not be interpreted as altering the level of assurance on any aspect of the audit report, including the identified critical audit matters.

e. Auditor Tenure

Some commenters stated that information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about

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[185] *See, e.g.*, Brasel et al., *Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability*; Kachelmeier et al., *The Disclaimer Effect of Disclosing Critical Audit Matters in the Auditor's Report*; or Brown et al., *The Impact of a Judgment Rule and Critical Audit Matters on Assessments of Auditor Legal Liability—The Moderating Role of Legal Knowledge*.

[186] *See, e.g.*, Backof et al., *The Impact of Proposed Changes to the Content of the Audit Report on Jurors' Assessments of Auditor Negligence*; or Gimbar et al., *The Effects of Critical Audit Matter Paragraphs and Accounting Standard Precision on Auditor Liability: Can Anything the Auditor Says Be Used Against Them?*

correlations between auditor tenure and audit quality. Academic research on the relationship of tenure to audit quality has varied conclusions. Some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.[187] Other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality.[188] Still other academic research suggests that, at least prior to 2001, both short tenure (less than five years) and long tenure (greater than fifteen years) can have detrimental effects on audit quality.[189]

The disclosure of auditor tenure is intended to add to the mix of information that investors can use. However, it is possible that some investors may draw incorrect inferences about auditor tenure that could have an unwarranted effect on cost of capital and could also result in conversations that are an inefficient use of management and audit committee time.

E. Alternatives Considered, Including Policy Choices Under the Reproposal

In developing the reproposal the Board considered alternative approaches to the proposed critical audit matters. The Board also considered certain policy decisions in developing critical audit matters and other changes to the auditor's report.

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[187] *See, e.g.*, Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 Auditing: A Journal of Practice & Theory 55, 55–69 (2004) and Timothy B. Bell, Monika Causholli, and W. Robert Knechel, *Audit Firm Tenure, Non–Audit Services, and Internal Assessments of Audit Quality*, 53 Journal of Accounting Research 461, 461–509 (2015).

[188] *See, e.g.*, Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 Accounting Horizons 297, 297–314 (2008).

[189] *See, e.g.*, Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 Contemporary Accounting Research 517, 517–548 (2009).

1. Alternative Approaches

a. No Change to Auditor Reporting Requirements

The Board considered whether changes to the existing auditor reporting requirements were needed. Auditor reporting under the current model has been criticized by many commenters as providing limited information. Auditors have not voluntarily provided more information in the auditor's report in response to investors' requests. A number of factors described above, such as potential costs and uncertainties related to voluntary auditor reporting and the potential for auditor status quo bias, may explain why voluntary reporting would not be expected to become prevalent. These factors suggest that voluntary reporting, with or without guidance to encourage it, could also create uncertainty about the content of auditor's reports because auditors would be able to choose whether to provide information about the audit, what information to provide, and the form in which to provide it. On that basis, the Board believes that standard setting is appropriate.

b. Consideration of Analogous Requirements of Other Regulators and Standard Setters

In developing the reproposal, the Board took into account the requirements for expanded auditor reporting of other regulators and standard setters, such as the IAASB, the FRC, and the EU. Changes to the auditor's report that other regulators and standard setters have adopted include some commonality, such as communicating information about audit-specific matters in the auditor's report. Adopting the expanded auditor reporting requirements of another standard setter could provide more consistent global auditor reporting requirements.

However, the Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Because the Board's standards have the force of law, the Board aims to make them as clear and easy to apply as it can. For example, the factors that the auditor would consider in determining whether a matter involved especially challenging, subjective, or complex auditor judgment are included in the standard; by contrast, while the IAASB approach includes similar factors, they appear in the application and other explanatory material.

In addition, there are differences between requirements and terminology of the Board's auditing standards and those of other regulators and standard setters that may cause inconsistent application, even if the Board were to adopt the approach of another standard setter. For example, the Board's requirements for communications to the audit committee are not the same as the analogous requirements of the IAASB. Therefore, although both critical audit matters and the IAASB's key audit matters are derived from such communications, the matters ultimately discussed with the audit committee under each framework would not necessarily be the same, and could result in differences in which matters are reported. Also, terminology used in the rules of other regulators and standard setters to describe matters subject to the expanded auditor reporting, such as IAASB's "areas of higher assessed risks of material misstatement" or EU's "most significant assessed risks of material misstatement," is not used in PCAOB auditing standards. As a result, adopting the same standard as another regulator or standard setter would not necessarily yield the same result.

c. Auditor's Association with Portions of MD&A

Several commenters suggested that the Board should consider auditor association with, or attestation on, portions of MD&A, specifically management's critical accounting policies and estimates, as an alternative to expanded auditor reporting. These commenters have argued that such an association could increase the quality and reliability of the information subject to the procedures. The Board solicited comment on this approach in the 2011 concept release and some commenters raised it again in relation to the 2013 proposal.

Some commenters on the 2011 concept release, including investors, said that they are not supportive of separate assurance by the auditor on information outside of the financial statements as an alternative to expanded auditor reporting, primarily because the related auditor reporting would have appeared in a standardized form and would not provide audit-specific information. Requiring such reporting might necessitate action by the SEC, as well as the PCAOB, to implement, including new SEC rules regarding management reporting and auditor attestation. In addition to reporting requirements, the PCAOB might have to develop new performance requirements and auditors would be required to undertake additional audit work in order to provide attestation in these areas. Based on concerns about the relative benefits and costs and the comments received, the Board determined not to pursue auditor association with portions of MD&A as an alternative to expanded auditor reporting.

d. Auditor Assessment and Descriptions of Certain Financial Statement Areas

As previously discussed, several commenters suggested that investors would be most interested in auditor reporting on the categories of information identified by investor respondents to the 2011 survey conducted by a working group of the IAG: (1) significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them;[190] (2) areas of high financial

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[190] Some commenters suggested that the auditor should grade their assessments.

statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.[191] This request was reiterated by several commenters on the 2013 proposal, who continued to believe that this approach would provide the information investors want most. In a similar vein, other commenters have requested that the auditor provide a "grade" assessing the quality of the financial statements as a whole.

The reproposed critical audit matter definition would likely cover many of the topic areas requested by investors. For example, the auditor may communicate critical audit matters related to significant management estimates and judgments, highlight areas of high financial statement and audit risk, and discuss significant unusual transactions. However, the auditor would not be required to report on its assessment of management's significant estimates and judgments or on the quality (as opposed to merely the acceptability), of the company's accounting practices and policies or of the financial statements as a whole.

In this standard setting, the Board seeks to strike an appropriate balance between the value of the information being provided and the costs of providing it. Requiring auditors to report their qualitative assessments in a manner that appears very precise (for example, describing an estimate as "conservative" or "aggressive" or assigning the financial statements an "A" or a "B") would likely impose significantly greater costs and unintended consequences than the principles-based reporting of critical audit matters. For example, although the reporting of qualitative assessments would appear to be precise, these qualitative assessments are likely to be applied inconsistently because there is no framework for such assessments and the determinations are inherently subjective. In addition, such assessments may heighten concerns related to the perceived level of assurance provided by the audit or the perception that separate assurance is being provided as to the assessed areas. Also, the reporting of such qualitative assessments would likely subject auditors and issuers to additional litigation risk beyond what may result from the principles-based reporting of critical audit matters because the apparent precision of the reporting may facilitate plaintiffs' claims.

2. Policy Choices

a. Definition of Critical Audit Matters

The Board considered a variety of possible approaches to the definition of critical audit matters suggested by commenters. *See* Section IV.A.1 for a discussion of the

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191 *See* IAG 2011 survey.

Board's considerations. Under the reproposal, the Board anticipates that the initial population of matters that could potentially be determined to be critical audit matters would be smaller than those under the proposal, which should reduce the auditor's effort in determining which matters may be critical audit matters. With a materiality component, however, matters that are not material to accounts or disclosures in the financial statements but may be important to investors would not be included as critical audit matters in the auditor's report.

b. Communication of Critical Audit Matters

The Board considered a variety of possible approaches to the communication requirements for critical audit matters. *See* Section IV.A.2 for a discussion of the Board's considerations. Under the reproposal, auditors would be required to describe how each critical audit matter was addressed in the audit, but are given flexibility in formulating the description, which should enable them to avoid standardized language and tailor the description to the specific circumstances for a particular audit. In addition, when describing critical audit matters in the auditor's report, the auditor would not be expected to provide information about the company that had not been made publicly available by the company unless such information were necessary to describe the principal considerations that led the auditor to determine that a matter was a critical audit matter or how the matter was addressed in the audit.

c. Documentation of Critical Audit Matters

In response to commenters' concern about the proposed requirement to document matters that appeared to meet the definition of critical audit matters, the documentation requirement in the reproposal was narrowed. *See* Section IV.A.3 for a discussion of the Board's considerations. In general, the reproposed documentation requirement is intended to facilitate review of the auditor's determinations by others, such as the engagement quality reviewer and through the Board's oversight activities. This should foster enhanced compliance and greater consistency in the application of the requirements. However, there would be additional time and effort related to the documentation requirement.

d. Auditor Tenure

The reproposal retains the requirement to include a statement in the auditor's report about auditor tenure. *See* Section IV.B.2 for a discussion of the Board's considerations. The reproposed requirement to disclose auditor tenure in the auditor's report would eliminate search costs stemming from duplicative efforts of investors and other financial statement users to individually gather the information, and would reduce search costs relative to manual review of Form 8-Ks and annual reports filed over time or locating *ad hoc* voluntary disclosure in the proxy statement. Under the reproposal, information about auditor tenure would be consistently available in one location, including with respect to companies that are not subject to the proxy rules.[192] Some commenters noted that the easier it is for investors to locate information about auditor tenure, the more useful such information would be. As a result, although there are varying views about the link between auditor tenure and audit quality, the Board's reproposal retains this requirement as another element in the mix of information used by investors in their decision making.

The Board is also soliciting comment on whether auditor tenure should be disclosed on Form AP rather than in the auditor's report. Relative to mandated disclosure in the auditor's report, disclosure on Form AP could further reduce search costs for market participants in some instances, particularly in aggregating data across audits and over time. However, under the reproposal, the required information would be disclosed in the auditor's report, the primary vehicle by which the auditor communicates with investors and where other information about the audit is already found, and would be available to investors immediately when a company files its audited financial statements and the accompanying auditor's report with the SEC.

e. Additional Improvements to the Auditor's Report

The reproposal includes a number of requirements that would enhance the standardized content of the auditor's report by clarifying the auditor's role and responsibilities related to the audit of the financial statements. These include, for example, statements regarding auditor independence requirements and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the reproposal includes requirements intended to promote uniformity in the form of the auditor's report. These include requirements as to the addressee, a specific order of certain sections of the auditor's report, and required section headings.

These enhancements should increase the usability of the auditor's report by improving financial statement users' understanding of the auditor's responsibilities, reducing search costs for information in the auditor's report, and facilitating comparisons across auditor's reports.

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[192] The proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, brokers and dealers, and most investment companies are not required to prepare proxy statements.

Questions:

27. How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?

28. How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?

29. Would critical audit matters be useful in assessing company financial performance? If so, how?

30. Would critical audit matters be useful in assessing audit quality? If so, how?

31. Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?

32. Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?

33. Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?

34. Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?

35. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

36. Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?

VII. Exclusions from Critical Audit Matter Requirements

Under the 2013 proposal, the standard would have applied to all audits conducted under PCAOB standards, although the Board sought comment on the applicability of critical audit matters to the audits of specific types of entities, including brokers and dealers; investment companies; and benefit plans. Some commenters supported applying the communication of critical audit matters to the audits of all types of entities. Others commented that audits of certain entities should be excluded from critical audit matter reporting. The Board has taken into consideration comments received and evaluated benefits and costs to assess the applicability of critical audit matters to the audits of brokers and dealers that are reporting under Exchange Act Rule 17a-5, investment companies and benefit plans. This section describes the Board's rationale, including economic considerations, for reproposing to exclude audits of these entities, other than business development companies, from the critical audit matter requirements.[193] However, auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

A. Brokers and Dealers

Pursuant to Exchange Act Rule 17a-5, brokers and dealers are generally required to file annual reports with the SEC and other regulators. The annual reports include, among other things, a financial report, either a compliance report or exemption report, and reports by the auditor covering the financial report and the compliance report or exemption report. The annual reports are public, except that if the statement of financial condition in the financial report is bound separately from the balance of the annual report, the balance of the annual report is deemed confidential and nonpublic.[194] In this situation, the auditor would generally issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete financial report that, except as provided in paragraph (c)(2)(iv) of Exchange Act Rule 17a-5, would be confidential and not available to the public.[195] Research by the

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[193] The other requirements of the reproposed standard would be applicable to audits of these types of entities.

[194] *See* Exchange Act Rule 17a-5(e), 17 CFR 240.17a-5(e).

[195] *See also* Exchange Act Rule 17a-5(c)(2), 17 CFR 240.17a-5(c)(2), regarding audited statements required to be provided to customers.

PCAOB's Office of Research and Analysis ("ORA")[196] indicates that, for approximately half of brokers and dealers, the complete financial report and the related auditor's report are confidential and not available to the public.

The SEC adopted new rules for brokers and dealers[197] and the Board adopted new standards most recently in 2013, after the issuance of the 2013 proposal. The Board's new standards enhanced the auditor's performance and reporting responsibilities for financial statement audits, as well as engagements on compliance and exemption reports of brokers and dealers.[198]

Research by ORA indicates that currently there are no brokers or dealers that are issuers. Rather, brokers and dealers are often owned by an individual or entity that holds a controlling interest. The owners of brokers and dealers are generally part of the management of the entity and therefore would have direct access to the auditor. Given that there is much less separation of ownership and control in non-issuer brokers and dealers, the communication of critical audit matters would provide little information about the audit that would otherwise be unobtainable by investors. Additionally, other financial statement users, such as counterparties or regulatory agencies, are in a position to obtain needed information from the brokers and dealers, suggesting that the communication of critical audit matters may be less beneficial for them.

However, there may be circumstances in which other financial statement users may benefit from reduced information asymmetry about the audits of brokers and dealers. But certain aspects of broker and dealer financial reporting may limit the benefits of requiring the communication of critical audit matters. For example, while other financial statement users, such as customers of brokers and dealers, may benefit from increased information about the audit, the ability for brokers and dealers to confidentially file certain financial statements and schedules would require the auditor to

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[196] ORA's research was conducted on brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014 that included audit reports issued by firms registered with the PCAOB.

[197] *See SEC*, *Broker-Dealer Reports,* Exchange Act Release No. 70073 (July 30, 2013), 78 FR 51910 (Aug. 21, 2013).

[198] *See Attestation Standards for Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-007 (Oct. 10, 2013) and *Auditing Standard on Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

identify and communicate critical audit matters that apply only to the publicly available statement of financial condition. This would impose additional costs on the auditors of brokers and dealers relative to the auditors of other types of companies, as they would have to identify critical audit matters that apply exclusively to the publicly available financial information. Moreover, customers of brokers and dealers may be interested in the overall financial position of the broker or dealer and may not benefit from audit-specific information in the same way as investors in an operating company.

Some commenters on the 2013 proposal asserted that the value of reporting critical audit matters for brokers and dealers would be significantly limited by: (1) the closely held nature of brokers and dealers; (2) the limited number of users of their financial statements; and (3) the fact that, in many cases, only the statement of financial condition is available publicly. Some commenters also recognized that both the SEC and PCAOB recently updated their rules to further enhance reporting by brokers and dealers and their auditors.

After consideration of the ownership and reporting characteristics of brokers and dealers, the comments received, and the Board's recent standard-setting activities related to brokers and dealers, the Board does not believe that reporting of critical audit matters for brokers and dealers would provide meaningful information in the same way as for issuers. Therefore, the communication of critical audit matters would not be required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5. If a broker or dealer were an issuer required to file audited financial statements under Section 13 or 15(d) of the Exchange Act, the requirements would apply.

B. Investment Companies

The Investment Company Act generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.[199] Most investment companies registered under the Investment Company Act are required to file with the SEC annual reports on Form N-CSR containing audited financial statements.[200] The Investment Company Act includes specific requirements for investment companies, intended to reduce investors' risks, in areas such as an investment company's portfolio diversification, liquidity, leverage, and custody of securities.[201]

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199 *See* Section 3(a)(1) of the Investment Company Act.

200 *See* SEC Rules under Section 30(e) of the Investment Company Act.

201 *See, e.g.,* Sections 12, 13, and 17 of the Investment Company Act.

In an SEC rulemaking, the SEC observed that commenters believed the key information that investors use in deciding to invest in an investment company includes an investment company's investment objectives, strategies, risks, costs, and performance.[202] The disclosure of information about these items appears in the annual prospectus that investment companies provide to current and future investors.[203] Changes to investment objectives and strategies require shareholder approval or disclosure.[204]

Several commenters on the 2013 proposal noted that an investor's decision to invest in an investment company is primarily based on the investment objectives, risks, performance, and fees, and critical audit matters are not expected to provide information about these items and therefore would not be relevant. Several commenters generally stated that investment companies are designed for the sole purpose of trading in and holding investments and auditor judgment would arise primarily with respect to valuation of investments, which would tend to be repeated as a critical audit matter. A commenter noted that, since the strategies of investment companies do not change significantly over time, the critical audit matters identified could become standardized from one reporting period to the next and also across funds with similar objectives.

Business development companies ("BDCs"), which are a type of investment company, differ from other investment companies in several important ways.[205] Other investment companies generally invest at least 85 percent of their assets in liquid investments, such as securities of public companies listed on a national securities exchange. BDCs, by contrast, are required to hold at least 70 percent of their assets in investments such as securities purchased in transactions not involving any public offering and eligible portfolio companies, e.g., private companies or small public companies that have no liquid securities.[206] As a result, BDCs' portfolios primarily

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[202] *See* SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 8998, 74 FR 4546 (Jan. 26, 2009). *See also* Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006), at 2–3.

[203] *See* SEC Rules under Section 30(e) of the Investment Company Act.

[204] *See* Sections 8(b) and 13(a)(3) of the Investment Company Act and Investment Company Act Rule 8b-16.

[205] BDCs make an election to be regulated under sections 55 through 65 of the Investment Company Act. *See* Section 54 of the Investment Company Act.

[206] *See* Sections 2(a)(46), 2(a)(48), and 55(a) of the Investment Company Act.

consist of securities that are highly illiquid, are often subject to sale restrictions, and are typically valued using unobservable inputs and valuation models.

Also, unlike other investment companies, BDCs are required to offer significant managerial assistance and can offer equity and loan financing to the companies they invest in.[207] BDCs are also able to use more leverage in their operations and issue types of debt and equity securities generally not issued by other investment companies.[208] Finally, BDCs are subject to registration and periodic reporting requirements under the Exchange Act, file their annual reports on Form 10-K,[209] and can qualify as emerging growth companies.[210] The Board did not receive any comments specific to BDCs.

Even though the disclosures required under the Investment Company Act and other federal securities laws provide investors with useful information, they may not fully substitute for the communication of critical audit matters. The required communication of critical audit matters contemplates that auditors would provide investors with audit-specific information, which is unlikely to appear in the disclosures provided by management. In addition, some academic research documented a difference in the perceived usefulness and reliability of information depending on the location of the disclosure and whether it was disclosed by management or by the independent auditor.[211] This academic research suggests that the auditor's communication of information similar to critical audit matters may provide value to investors because it comes from the auditor, even if the same information is disclosed by management in the experimental design of the study.

The benefits of providing critical audit matters, however, may be smaller for investment companies, other than BDCs, relative to other types of companies because

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[207] *See* Section 2(a)(47) of the Investment Company Act.

[208] *See* Section 61 of the Investment Company Act.

[209] *See* Section 54 of the Investment Company Act.

[210] Under SEC staff interpretation, BDCs can qualify as emerging growth companies. *See* Division of Corporation Finance, *Jumpstart Our Business Startups Act Frequently Asked Questions*, Q. 21. Other investment companies cannot qualify as emerging growth companies. *See* Division of Corporation Finance, *Jumpstart Our Business Startups Act Frequently Asked Questions*, Q. 20.

[211] *See, e.g.*, Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

of their purpose and structure. Unlike companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. This creates the potential for critical audit matters of investment companies to become excessively repetitive, making them uninformative.

There may also be additional costs of applying critical audit matter requirements to audits of investment companies, other than BDCs, as compared to audits of other types of companies. For example, in some cases, annual shareholder reports of affiliated investment companies with the same fiscal year-end might be filed with the SEC in one document, which generally contains a single auditor's report that covers multiple audited investment companies. In these situations, communicating critical audit matters specific to each investment company may require the auditor to prepare separate auditor's reports. This could increase costs for these types of investment companies.

After consideration of the purpose and reporting characteristics of investment companies and the comments received, the communication of critical audit matters would not be required for audits of most investment companies. The requirements would apply, however, to investment companies regulated as BDCs.[212] Unlike the audits of many other investment companies, auditing the valuation of BDCs' investments would generally involve complexity and auditor judgments due to the nature of the BDCs' portfolios. Also, because of the more diverse operations of BDCs, such as providing managerial assistance and involvement with more complex debt and equity instruments than other investment companies, communication of critical audit matters in a BDC audit could be more informative to investors. Additionally, BDCs follow a reporting regime under the Exchange Act that is more closely aligned with that of companies to which the Board is applying the requirements for critical audit matters. For these reasons, the Board believes it would be appropriate for audits of BDCs to be subject to critical audit matter requirements.

C. Benefit Plans

Benefit plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K[213] that includes the benefit plan's audited financial statements and the

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[212] *See* Section 54 of the Investment Company Act.

[213] *See* Section 15(d) of the Exchange Act.

related auditor's report.[214] The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.[215]

Participation in a benefit plan is limited to eligible employees of the plan sponsor. Each plan participant in a defined contribution benefit plan is responsible for selecting, from the investment options made available by the plan sponsor, the specific investments in which the participant's funds are invested.

Employee stock benefit plans are generally less complex than other types of companies because they are designed for the sole purpose of holding the plan's investments for the participants' benefit. A plan's financial statements reflect summary information about the plan's assets and liabilities by aggregating the balances of all plan participants. However, only the individual account statements that plan participants receive periodically provide information specific to each participant's investments.

Several commenters suggested excluding audits of benefit plans from the requirement for reporting critical audit matters due to the unique characteristics of these entities and their differences from other types of companies. For example, some commenters indicated that benefit plans are designed for a specific purpose and, as a result, would likely have similar critical audit matters from one reporting period to the next. Other commenters noted that benefit plans are inherently less complex and entail fewer estimates and judgments.

The communication of critical audit matters could provide information about any complex issues that were identified during the audit and how the auditor addressed them. However, since a benefit plan's assets and liabilities aggregate the balances of all plan participants, the financial statements or related critical audit matters would not provide actionable information about a plan participant's specific investment. Further, given the nature of benefit plans, there is a chance that the same critical audit matters

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[214] A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. *See* SEC Rule 15d-21, CFR 240.15d-21.

[215] *See* FASB ASC 960-10-05-6. Benefit plans subject to ERISA also file with the DOL an annual report on Form 5500, including audited financial statements and an auditor's report. Pursuant to DOL requirements, the audit of the financial statements is performed under auditing standards generally accepted in the United States, that is, not under PCAOB standards.

would be communicated each year. For example, the valuation of investments is likely to be the most complex area in the audit of a benefit plan and therefore may be a critical audit matter in each reporting period, making the information less useful.

After consideration of the structure and reporting characteristics of benefit plans and the comments received, the communication of critical audit matters would not be required for audits of benefit plans.

Requirements of Other Regulators and Standard Setters

Under the IAASB's standard, the communication of key audit matters applies to listed entities.[216] The EU requirements apply to audits of PIEs, including listed companies, credit institutions, and insurance companies.[217] The FRC 2013 requirements apply to auditor's reports for entities that apply the UK Corporate Governance Code.[218]

Questions:

37. Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?

38. For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?

39. While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?

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[216] *See* paragraph 5 of ISA 701.

[217] *See* requirements in 1 of Article 2, *Audit Report* of Regulation (EU) No 537/2014.

[218] These include companies with a premium listing of equity shares on the London Stock Exchange regardless of whether they are incorporated in the U.K. or elsewhere.

40. Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies?[219] Why or why not?

VIII. Considerations for Audits of Emerging Growth Companies

Section 104 of the Jumpstart Our Business Startups ("JOBS") Act imposes certain limitations with respect to application of the Board's standards to audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Exchange Act. Section 104 provides that "[a]ny rules of the Board requiring . . . a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company . . ."[220] In addition, Section 104 further provides that any other rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[221] As a result of the JOBS Act, the reproposed standard and amendments, if adopted by the Board, would be subject to an evaluation as to whether they could, and if so, should be applicable to the audits of EGCs.

The 2013 proposal solicited comment on the application of the proposed standard to the audits of EGCs. Two commenters suggested that it would violate the JOBS Act provisions regarding AD&A for the Board to apply critical audit matter requirements to the audits of EGCs, on the basis that critical audit matters are

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[219] A shell company is defined as a company, other than an asset-backed issuer, with no or nominal operations; and either: no or nominal assets; assets consisting of cash and cash equivalents; or assets consisting of any amount of cash and cash equivalents and nominal other assets. *See* Exchange Act Rule 12b-2.

[220] *See* Pub. L. No. 112-106 (Apr. 5, 2012). *See* Section 103(a)(3)(C) of Sarbanes-Oxley, (15 U.S.C. 7213(a)(3)), as added by Section 104 of the JOBS Act. An auditor's discussion and analysis ("AD&A") does not exist in auditing standards but was described as one of several conceptual alternatives for changing the auditor's reporting model in the 2011 concept release. Section IV.A., *Auditor's Discussion and Analysis,* of the 2013 proposal described an AD&A and related comments received on the concept release.

[221] *Id*.

"substantially similar"[222] or "appear substantively similar"[223] to AD&A. One of these commenters further asserted that applying the critical audit matters standard to audits of all issuers, regardless of EGC status, would violate the spirit of the "IPO On-Ramp" embedded in the JOBS Act by applying a one-size-fits all compliance burden, with potentially significant costs, to smaller issuers.

Other commenters, including accounting firms that commented on this issue, asserted that the proposed standard should apply to audits of EGCs. Some of these commenters argued that EGCs exhibit characteristics similar to other public companies and that financial statement users would benefit from similar auditor reporting requirements. Some commenters asserted that the proposed standard should be applicable to EGCs on a deferred basis, after its implementation by larger companies has been evaluated for effectiveness.

Academic research suggests that EGCs may have a higher degree of information asymmetry relative to the broader population of issuers. Although the degree of information asymmetry surrounding a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.[224] The extent to which EGCs can be characterized as exhibiting one or more of these properties may suggest that they have a greater degree of information asymmetry relative to the broader population of issuers. As a result, the benefits of reducing the degree of information asymmetry about audit and financial reporting quality may be incrementally larger for EGCs relative to the broader population of operating companies. For example, in a UK study using analyst following as a proxy for a company's information environment, the authors found that

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[222] *See* letter from the Biotechnology Industry Organization (Dec. 9, 2013), at 2.

[223] *See* letter from the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Dec. 9, 2013), at 4.

[224] *See*, *e.g.*, David Aboody, and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 The Journal of Finance 2747, 2747-2766 (2000), and Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 Journal of Financial Economics 361, 361-381 (1995), and Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 Journal of Financial Economics 101, 101-121 (1988), and Raymond Chiang, and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A note*, 43 The Journal of Finance 1041, 1041-1048 (1988).

companies with low analyst following experienced a statistically significant increase in abnormal trading volume following the implementation of the enhanced audit reporting requirements. The authors of the study argued that enhanced audit reporting produced greater benefits for companies with weaker information environments.

The data on EGCs outlined in Appendix 3, *Characteristics of Self-Identified EGCs*, remains generally consistent with the data discussed in the 2013 proposal, although the number of EGCs has more than doubled since 2013. A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.[225]

If the reproposed standard does not apply to audits of EGCs but is applicable to audits of larger and more established companies, there could be potential disparity between the two groups of companies in the amount and quality of public information available for investment decision making. Excluding EGCs from the reproposed standard could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a competitive disadvantage compared to non-EGCs in attracting available capital.

The Board must also take into account the potential costs of applying critical audit matter requirements to EGCs. A detailed discussion of the potential costs, including unintended consequences, of critical audit matter requirements appears in Section VI. It should be noted that because EGCs tend to be smaller than the broader population of operating companies, the costs of compliance could affect EGCs disproportionately.

At this time, no determination has been made about the applicability of the reproposed standard and amendments to the audits of EGCs; such a determination would be made at adoption, based on the provisions of the final auditing standard and related amendments. If all or part of the standard and amendments were not to apply to the audits of EGCs, this determination would not preclude auditors of EGCs from applying such provisions voluntarily.

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[225] *See* SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission*, (Apr. 23, 2006), at 73.

Questions:

41. Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? Should the reproposed requirements be modified to make their application to EGCs more appropriate? Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?

42. If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?

43. Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?

IX. <u>Considerations Related to Effective Date</u>

The 2013 proposal sought comment on whether any special consideration should be given to a delayed compliance date for the proposed standard, such as for the audits of smaller companies. Some commenters stated that the Board should consider delaying effectiveness for audits of smaller companies, including smaller reporting companies and nonaccelerated filers.

The Board continues to seek comment on the effective date related to the reproposed standard and amendments. The Board's final decision on the effective date would take into account the nature and extent of comments received on the reproposal and the timing of Board adoption of any final standard and amendments, subject to approval by the SEC.

Question:

44. If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? If so, what criterion should the Board use to classify companies, for example smaller reporting companies? Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?

X. Opportunity for Public Comment

The Board is seeking comment on all aspects of the reproposed standard and amendments as well as on the specific questions included in this reproposal. Among other things, the Board is seeking comment on economic considerations relating to the reproposed standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters, regarding the reproposed standard and amendments. Commenters providing cost estimates are requested to provide the basis for their estimates.

Studies, memoranda, or other substantive items may be added by the Board or staff to Docket 034 during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Board's website. To ensure direct electronic receipt of such notifications via email, subscribe to PCAOB updates at http://pcaobus.org/About/Pages/PCAOBUpdates.aspx.

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket No. 034 on the subject or reference line and should be received by the Board by August 15, 2016.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the reproposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under Sarbanes-Oxley.

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On the 11th day of May, in the year 2016, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

PCAOB
Public Company Accounting Oversight Board

APPENDIX 1

[Paragraph .10 and paragraphs .20 through .76 of AS 3101 (currently AU sec. 508),[1] *Reports on Audited Financial Statements*, are proposed to be redesignated as AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances.* AS 3101 is proposed to be retitled and the remaining paragraphs are amended as follows:]

Proposed AS 3101*, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

Introduction

.01 The auditor's report contains either an expression of opinion on the financial statements,[2] taken as a whole,[3] or an assertion that an opinion cannot be expressed. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report").[4]

.02 The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and

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[1] Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final standard.

[2] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. *See* SEC Rule 1-01(b) of Regulation S-X, 17 CFR 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; *see*, *e.g.*, AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement*.

[3] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[4] Paragraphs .85-.98 and Appendix C, *Special Reporting Situations*, of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,[5] in conformity with the applicable financial reporting framework.[6]

.03 When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements and state the reasons for the departure from the unqualified opinion. AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances* (currently AU sec. 508, *Reports on Audited Financial Statements*), describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

Objectives

.04 The objectives of the auditor when the auditor concludes that an unqualified opinion is appropriate are to:

a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

b. Communicate in the auditor's unqualified report **critical audit matters,**[7] relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

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[5] AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"* (currently AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*), describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

[6] The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

[7] This term is defined in Appendix A, *Definitions*, and is set in **boldface type** the first time it appears.

The Auditor's Unqualified Report

.05 The auditor's unqualified report includes:[8]

a. The basic elements,[9] as described in paragraphs .06-.10;

b. Communication regarding critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs .11-.17, unless such requirements do not apply;

Note: Communication of critical audit matters is not required for audits of (1) brokers[10] and dealers[11] reporting under Exchange Act Rule 17a-5; (2) investment companies registered under the Investment Company Act of 1940 ("Investment Company Act");[12] other than companies that have elected to be regulated as business development companies;[13] and (3) employee stock purchase, savings, and similar plans.[14]

c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs .18-.19; and

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8 Appendix B provides an illustrative auditor's unqualified report.

9 Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. *See*, *e.g.,* Sections 30(g) and 32(a)(4) of the Investment Company Act; Rule 2-02 of Regulation S-X, 17 CFR 210.2-02; and Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR 240.17a-5. Auditor's reports on financial statements filed with the SEC are subject to all such applicable requirements.

10 *See* PCAOB Rule 1001(b)(iii).

11 *See* PCAOB Rule 1001(d)(iii).

12 *See* Section 8 of the Investment Company Act.

13 *See* Section 54 of the Investment Company Act.

14 *See* Exchange Act Rule 15d-21, 17 CFR 240.15d-21.

d. Information about certain audit participants, if the auditor decides to provide this information in the auditor's report, as described in paragraph .20.

Basic Elements

Title

.06 The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

Addressee

.07 The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

Opinion on the Financial Statements

.08 The first section of the auditor's report must include the section title "Opinion on the Financial Statements" and the following elements:

a. The name of the company whose financial statements were audited;

b. A statement identifying each financial statement and any related schedule(s) that has been audited;[15]

c. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;

d. A statement indicating that the financial statements, including the related notes and any related schedule(s), identified and

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[15] Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. *See*, *e.g.,* Rules 5-04, 6-10, 6A-05, and 7-05 of Regulation S-X, 17 CFR 210.5-04, 210.6-10, 210.6A-05, 210.7-05. *See generally*, Rule 12-01 of Regulation S-X, 17 CFR 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

collectively referred to in the report as the financial statements, were audited; and

e. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.[16] The opinion should also include an identification of the applicable financial reporting framework.

Basis for Opinion

.09 The second section of the auditor's report must include the section title "Basis for Opinion" and the following elements:

a. A statement that the financial statements are the responsibility of the company's management;

b. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;

c. A statement that the audit was conducted in accordance with the standards of the PCAOB;

d. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

e. A statement that an audit includes:

(1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

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[16] The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and financial statements being audited.

(2) Examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements;

(3) Evaluating the accounting principles used and significant estimates made by management; and

(4) Evaluating the overall presentation of the financial statements;

f. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion; and

g. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

Signature, Tenure, Location, and Date

.10 The auditor's report must include the following elements:

a. The signature of the auditor's firm;[17]

b. A statement containing the year the auditor began serving consecutively as the company's auditor;[18]

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership

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[17] *See* Rule 2-02(a) of Regulation S-X, 17 CFR 210.2-02(a).

[18] For an investment company that is part of a group of investment companies, the statement contains the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. *See* Section 12(d)(1)(G)(ii) of the Investment Company Act.

structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

c. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;[19] and

d. The date of the auditor's report.[20]

Critical Audit Matters

Determination of Critical Audit Matters

.11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are not a substitute for the auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105).

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

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[19] *See* Regulation S-X Rule 2-02(a).

[20] *See* AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report*.

c. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;

d. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

e. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

f. The nature of audit evidence obtained regarding the matter.

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

Communication of Critical Audit Matters

.13 The auditor must communicate in the auditor's report critical audit matters[21] relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period's financial statements are presented on a comparative basis with those of one or more prior periods, the auditor may communicate critical audit matters relating to a prior period when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2)

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[21] Critical audit matters are not a substitute for required explanatory language (paragraphs) described in paragraph .18. If a matter that meets the definition of a critical audit matter also requires an explanatory paragraph, such as a matter related to going concern, the auditor may include the information required under paragraph .14 in the explanatory paragraph with a cross-reference in the critical audit matters section of the auditor's report to the explanatory paragraph. Alternatively, the auditor may include the explanatory paragraph and critical audit matter communication separately in the auditor's report and add a cross-reference between the two sections.

issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

.14 For each critical audit matter communicated in the auditor's report the auditor must:

a. Identify the critical audit matter;

b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;

c. Describe how the critical audit matter was addressed in the audit; and

d. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

Note 2: When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Language Preceding Critical Audit Matters in the Auditor's Report

.15 The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

.16 In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

Critical Audit Matters

Critical audit matters are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.

Documentation of Critical Audit Matters

.17 The auditor must document the basis for the auditor's determination whether each matter that both:

a. Was communicated or required to be communicated to the audit committee; and

b. Relates to accounts or disclosures that are material to the financial statements

involved especially challenging, subjective, or complex auditor judgment.[22]

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[22] Consistent with the requirements of AS 1215, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the determinations made to comply with the provisions of this standard.

Explanatory Language Added to the Auditor's Report

.18 Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report. These circumstances include when:

a. There is substantial doubt about the company's ability to continue as a going concern;[23]

b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;[24]

c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;[25]

d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;[26]

e. A material misstatement in previously issued financial statements has been corrected;[27]

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[23] *See* AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (currently AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*).

[24] *See* paragraphs .06-.09 of AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors).*

[25] *See* paragraphs .08 and .12-.15 of AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements,* (as proposed to be amended).

[26] *See* AS 2820.06.

[27] *See* AS 2820.09 and .16-.17 (as proposed to be amended).

f. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;[28]

g. Management is required to report on the company's internal controls over financial reporting but such report is not required to be audited,[29] and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of the company's internal control over financial reporting; [30]

h. Certain circumstances relating to reports on comparative financial statements exist;[31]

i. Selected quarterly financial data required by Item 302(a) of Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;[32]

j. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether

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[28] *See* AS 2201.88. AS 2201 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, AS 2201 notes that the auditor should consider those circumstances as well.

[29] *See* Item 308 of Regulation S-K.

[30] *See* AS 3105.59-.60 (as proposed to be amended).

[31] *See* AS 3105.52-.53 and .56-.58.

[32] *See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*).

the supplementary information conforms to the requirements of the applicable financial reporting framework;[33]

k. There has been a change in an investee year end that has a material effect on the company's financial statements; and[34]

l. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements.[35]

Emphasis of a Matter

.19 The auditor may emphasize a matter regarding the financial statements in the auditor's report ("emphasis paragraph").[36] The following are examples of matters, among others, that might be emphasized in the auditor's report:[37]

a. Significant transactions, including significant transactions with related parties;

b. Unusually important subsequent events, such as a catastrophe that has had, or continues to have, a significant effect on the company's financial position;

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[33] *See* paragraphs .03 and .08 of AS 2705 (currently AU sec. 558), *Required Supplementary Information*.

[34] *See* paragraph .32 of AS 2503 (currently AU sec. 332), *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[35] *See* paragraph .04 of AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements*.

[36] Emphasis paragraphs are never required and are not a substitute for required critical audit matters described in paragraphs .11-.17.

[37] It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" in the opinion paragraph when an emphasis paragraph is included in the auditor's report.

c. Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period;

d. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and

e. That the entity is a component of a larger business enterprise.

If the auditor adds an emphasis paragraph in the auditor's report, the auditor should use an appropriate section title.

Information about Certain Audit Participants

.20 The auditor may include in the auditor's report information regarding the engagement partner and/or other accounting firms participating in the audit that is required to be reported on PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*.[38] If the auditor decides to provide information about the engagement partner, other accounting firms participating in the audit, or both, the auditor must disclose the following:

a. *Engagement partner*—the engagement partner's full name as required on Form AP; or

b. *Other accounting firms participating in the audit*:

i. A statement that the auditor is responsible for the audits or audit procedures performed by the other public accounting firms and has supervised or performed procedures to assume responsibility for their work in accordance with PCAOB standards;

ii. *Other accounting firms individually contributing 5% or more of total audit hour*s—for each firm, (1) the firm's legal name, (2) the city and state (or, if outside the United States, city and country) of headquarters' office, and (3) percentage of

[38] If the auditor decides to include information regarding certain audit participants in the auditor's report, the auditor should use an appropriate section title.

total audit hours as a single number or within an appropriate range, as is required to be reported on Form AP; and

iii. *Other accounting firms individually contributing less than 5% of total audit hours*—(1) the number of other accounting firms individually representing less than 5% of total audit hours and (2) the aggregate percentage of total audit hours of such firms as a single number or within an appropriate range, as is required to be reported on Form AP.

APPENDIX A – Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matter – Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

> Note: Required audit committee communications are set forth in PCAOB standards, including AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees*, and Appendix B of that standard which refers to other PCAOB standards.

APPENDIX B – An Illustrative Auditor's Unqualified Report Including Critical Audit Matters

[Changes from the current illustrative report are underlined]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company *as of* [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [*the applicable financial reporting framework*].

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[*Include critical audit matters*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

APPENDIX 2

Amendments to Other PCAOB Standards Related to the Proposed Standard

In connection with the proposed standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "reproposed standard"), the Board is proposing amendments to several of its other auditing standards as set out below.[1] Language that would be deleted by the proposed amendments is struck through. Language that would be added is underlined. Language proposed to be moved without being modified, such as changes to the illustrative auditor's report to conform to the required order in the proposed standard, is double underlined.

Contents

I. Proposed Amendments to AS 3105 2
II. Proposed Amendments to Auditing Standards 46
III. Proposed Amendments to Auditing Interpretations 90

[1] Some of these auditing standards, such as AS 3105, may need further updating, which the Board may consider under separate standard-setting projects. If, prior to the conclusion of this rulemaking, the Board has adopted amendments related to other standard-setting projects that affect the amendments reproposed in this release, the Board may make conforming changes to the reproposed standard and amendments. The reproposed amendments would amend specific auditing standards to reflect changes to the auditor's unqualified report.

I. Proposed Amendments to AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

~~**AS 3101: Reports on Audited Financial Statements**~~ **AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances (currently AU sec. 508, Reports on Audited Financial Statements)*[2]**

Introduction

~~.01 This section applies to auditors' reports issued in connection with audits[1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

~~Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs .85-.98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201, for direction on reporting on internal control over financial reporting. In addition, *see* AS 2201.86-.88, which includes an illustrative combined audit report.~~

~~[1] An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with the standards of the PCAOB in effect at the time the audit is performed. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~.02 This section does not apply to unaudited financial statements as described in AS 3320, *Association with Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in AS 3305, *Special Reports*.~~

[2] Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final amendments.

~~.03 Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with the standards of the PCAOB and on the findings. This section is concerned primarily with the relationship of the requirements in paragraph .04 to the language of the auditor's report.~~

~~.04 The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~.05 The objective of the requirements in paragraph .04 is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in paragraph .04 to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the requirements in paragraph .04 as it applies to comparative financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

~~The Auditor's Standard Report~~

~~.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with the standards of the PCAOB.~~

~~.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope~~

~~paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

~~*a.* A title that includes the word *independent*[3]~~

~~[3] This section does not require a title for an auditor's report if the auditor is not independent. *See* AS 3320 for guidance on reporting when the auditor is not independent.~~

~~*b.* A statement that the financial statements identified in the report were audited~~

~~*c.* A statement that the financial statements are the responsibility of the Company's management[4] and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~

~~[4] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~*d.* A statement that the audit was conducted in accordance with the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States))~~

~~*e.* A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~

~~*f.* A statement that an audit includes~~

~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~
~~(2) Assessing the accounting principles used and significant estimates made by management~~
~~(3) Evaluating the overall financial statement presentation[5]~~

~~[5] Paragraphs .03 and .04 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* discuss the auditor's evaluation of the overall presentation of the financial statements.~~

~~*g.* A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~*h.* An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles)~~

~~*i.* The manual or printed signature of the auditor's firm~~

~~*j.* The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued[6A]~~

~~[6A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

~~*k.* The date[7] of the audit report~~

~~[7] For guidance on dating the auditor's report, *see* AS 3110, *Dating of the Independent Auditor's Report*.~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as~~

~~evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

[~~*Signature*~~]

[~~*City and State or Country*~~]

[~~*Date*~~]

~~The form of the auditor's standard report on comparative financial statements[8] is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~[8] If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]."~~

~~*l.* When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

> ~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

.01~~0~~ The auditor's report contains either an expression of opinion on the financial statements, taken as a whole,[1] or an assertion that an opinion cannot be expressed. This standard ~~section~~ ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard~~ auditor's unqualified report[2] and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented~~; this section describes what is meant by the various audit opinions~~:

- ~~*Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.~~

- ~~*Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.~~

- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .02 -.39.

- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .40 -.43.

- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. *See* paragraphs .44 -.47.

~~These opinions are discussed in greater detail throughout the remainder of this section.~~ This standard also discusses other reporting circumstances, such as reports on comparative financial statements.

[1] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[2] AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). Paragraphs .85–.98 of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and

Appendix C, *Special Reporting Situations*, of AS 2201 address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting. *See also* AS 2201.86–.88, which includes an illustrative combined audit report.

~~Explanatory Language Added to the Auditor's Standard Report~~

~~.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory[9] paragraph (or other explanatory language) to the standard report.[10] These circumstances include:~~

~~[9] Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.~~

~~[10] *See* footnote 3.~~

> ~~*a.* The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~
>
> ~~*b.* There is substantial doubt about the entity's ability to continue as a going concern.[11]~~

~~[11] AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions.~~

> ~~*c.* There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~
>
> ~~*d.* A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~
>
> ~~*e.* Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~
>
> ~~*f.* Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (*See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.)~~

~~*g.* Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (*See* paragraph .02 of AS 2705, *Required Supplementary Information*.)~~

~~*h.* Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (*See* paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19).~~

~~Opinion Based in Part on Report of Another Auditor~~

~~.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (*See* AS 1205, *Part of the Audit Performed by Other Independent Auditors*.)~~

~~.13 An example of a report indicating a division of responsibility follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those~~

> ~~statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~
>
> ~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~
>
> ~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[.14-.15] [Paragraphs deleted.]~~

~~Lack of Consistency~~

~~.16 The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

- ~~*a.* A change in accounting principle.~~
- ~~*b.* An adjustment to correct a misstatement in previously issued financial statements.~~

~~Change in Accounting Principle~~

~~.17A As discussed in AS 2820, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are~~

~~adequate, and (4) the company has justified that the alternative accounting principle is preferable.[12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

~~[12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. *See* FASB Statement 154, paragraph 14.~~

~~.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].~~

~~.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].~~

~~.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

~~.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a~~

~~departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

~~Correction of a Material Misstatement in Previously Issued Financial Statements~~

~~.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

> ~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

~~[13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.~~

~~.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

~~.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

~~Emphasis of a Matter~~

~~.19 In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are~~

- ~~That the entity is a component of a larger business enterprise.~~

- ~~That the entity has had significant transactions with related parties.~~

- ~~Unusually important subsequent events.~~

- ~~Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.~~

~~Departures From Unqualified Opinions~~

Qualified Opinions

.02~~0~~ Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

a. There is a lack of sufficient appropriate evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion (paragraphs .05~~22~~–.17~~34~~).

b. The auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion (paragraphs .18~~35~~–.39~~57~~).

.03 When the auditor expresses a qualified opinion, the auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101.

.04~~21~~ When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the auditor's report. The auditor should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph that discloses all of the substantive reasons for the qualified opinion. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used.

Note: The auditor should refer to AS 3101 to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter.

Scope Limitations

.05~~22~~ The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with the standards of the PCAOB and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

.06~~23~~ The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.07~~24~~ Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors.[31~~14~~] Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he or she has examined sufficient appropriate evidential matter to permit him or her to express an unqualified or qualified opinion, or whether he or she should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements.

[31~~14~~] Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that AS 2510, *Auditing Inventories*, states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.08~~25~~ When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the ~~situation~~ auditor's report should ~~be~~ describe~~d~~ the basis for departure from an unqualified opinion in a~~n~~ ~~explanatory~~ separate paragraph ~~preceding~~ immediately following the opinion paragraph and refer~~red~~ to that description in both the ~~scope~~ Basis for Opinion section and opinion paragraph~~s~~ of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client.

.09~~26~~ When an auditor qualifies his or her opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

~~[*Same first paragraph as the standard report*]~~

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of ~~such~~ the adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, as described below, the financial statements ~~referred to in the first~~

~~paragraph above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as discussed ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures include~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also include~~s~~d ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.10~~27~~ ***Other scope limitations.*** Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he or she deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he or she considers necessary, the auditor should qualify his or her opinion or disclaim an opinion because of a limitation on the scope of the audit.

.11~~28~~ If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report,* states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, the auditor's only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances.

.12~~29~~ ***Uncertainties and scope limitations.*** A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and matters related to estimates covered by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.13~~30~~ Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with generally accepted accounting principles, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.14~~31~~ If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

.15~~32~~ Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from generally accepted accounting principles related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. Paragraphs .28~~45~~ to .32~~49~~ provide guidance to the auditor when financial statements contain departures from generally accepted accounting principles related to uncertainties.

.16~~33~~ ***Limited reporting engagements.*** The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

.17~~34~~ An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statement

We have audited the accompanying balance sheet of X Company (the "Company") as of December 31, 20XX, and the related notes [*and schedules*] (collectively referred to as the "financial statement"). In our opinion, ~~the balance sheet referred to above~~ the financial statement presents fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatements of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures include~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement.

~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

Departure From a Generally Accepted Accounting Principle

.18~~35~~ When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with the standards of the PCAOB, he or she should express a qualified (paragraphs .19~~36~~ through .39~~57~~) or an adverse (paragraphs .40~~58~~ through .43~~60~~) opinion. The basis for such opinion should be stated in the report.

.19~~36~~ In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magnitude of such effects. However, the concept of materiality does not depend entirely on relative size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.20~~37~~ When the auditor expresses a qualified opinion, he or she should disclose, in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph ~~of the report~~ should include the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion.

.21~~38~~ The ~~explanatory~~ paragraph(s) immediately following the opinion paragraph that describe the substantive reasons that led the auditor to conclude that there has been a departure from generally accepted accounting principles should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.[4~~15~~] If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion may be shortened by referring to it.

[4~~15~~] In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information. For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the report.

.22~~39~~ An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the ~~preceding~~ following paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.23~~40~~ If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (~~preceding~~ immediately following the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .22~~39~~ might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

.24~~41~~ ***Inadequate disclosure.*** Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable,[5]~~[16]~~ unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB standard.

[5]~~[16]~~ *See* footnote 4~~15~~.

.25~~42~~ Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the omission of the information discussed in the ~~preceding~~ following paragraph, . . .

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.26~~43~~ If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.

.2744 ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report~~ ~~i~~If the company's management declines to present ~~the statement~~ a basic financial statement (for example, a statement of cash flows for one or more periods)~~.~~ ~~Accordingly, in these cases~~, the auditor should ordinarily qualify the report in the following manner:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of operations, and stockholders' equity for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements").~~income and retained earnings for the years then ended.~~ In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.28~~45~~ ***Departures from generally accepted accounting principles involving risks or uncertainties, and materiality considerations.*** Departures from generally accepted accounting principles involving risks or uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraphs .29~~46~~ and .30~~47~~)
- Inappropriate accounting principles (paragraph .31~~48~~)
- Unreasonable accounting estimates (paragraph .32~~49~~)

.29~~46~~ If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, the auditor should express a qualified or an adverse opinion.

.30~~47~~ The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to his or her evaluation of the materiality of known and likely misstatements in the financial statements.

.31~~48~~ In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates ordinarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 23 and 25, describes situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

.32~~49~~ Usually, the auditor is able to satisfy himself or herself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (*see* paragraph .13 of AS 2810, *Evaluating Audit Results*) and that its effect is to cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

~~[.50]~~

.33~~51~~ ***Departures from generally accepted accounting principles related to changes in accounting principle***. Paragraph .07 ~~.17A~~ of AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*, ~~states~~ includes the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

.34~~52~~ The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the change in accounting principle discussed in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.[6]~~[17]~~

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[6~~17~~] Because this paragraph included in the example presented contains all of the information required in a~~n~~ ~~explanatory~~ separate paragraph on consistency, an ~~separate~~ explanatory paragraph (immediately following the opinion paragraph) as required by ~~paragraphs .17A thorough .17E of this section~~ AS 2820.08 and .12-.15 (currently Auditing Standard No. 6) is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs.

.35~~53~~ Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, the auditor should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .36~~54~~ through .39~~57~~.

.36~~54~~ If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his or her reservations with respect to the statements for the year of change.

.37~~55~~ If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year.

.38~~56~~ If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.39~~57~~ If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .34~~52~~, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

Adverse Opinions

.40 When the auditor expresses an adverse opinion, the auditor's report must include the opinion as described in paragraph .41 and the same other basic elements as would be required in an unqualified auditor's report under AS 3101, modified appropriately.

> Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor expresses an adverse opinion.

.41~~58~~ An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42~~59~~ When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[7][~~18~~] If the effects are not reasonably determinable, the report should so state.[8][~~19~~]

[7][~~18~~] *See* footnote 4~~15~~.

[8][~~19~~] When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in ~~paragraph 11, subsection (*b*), (*c*), (*d*), and (*e*) of~~ AS 3101.18 ~~this section~~.

.43~~60~~ When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.~~,~~ An example of this is ~~as~~ shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, because of the effects of the matters discussed in the ~~preceding~~ following paragraphs, the financial statements ~~referred to above~~ do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *This section includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

Disclaimer of Opinion

.44~~61~~ A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

.45~~62~~ A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.[~~20~~9] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (*see* paragraphs .18~~35~~ through .39~~57~~). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles.

.46 When the auditor disclaims an opinion, the auditor's report must include the same basic elements as would be required in an unqualified auditor's report under AS 3101, modified appropriately.

> Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor disclaims an opinion.

.47~~63~~ An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Disclaimer of Opinion on the Financial Statements

We were engaged to audit the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements").[10~~21~~] ~~Since~~ As described in the following paragraph, because the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $________ as of December 31, 20X2, and at $_________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Basis for Opinion

These financial statements are the responsibility of the Company's management. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

[~~*Second paragraph of standard report should be omitted*~~ *The remaining basic elements in the Basis for Opinion section of the auditor's unqualified report*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[10]~~[21]~~ The wording in the ~~first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The~~ first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with the standards of the PCAOB. In addition, the ~~last~~ sentence ~~of the first paragraph is also deleted, because of the scope limitation, to eliminate the~~ that references ~~to~~ the auditor's responsibility to express an opinion is deleted.

Piecemeal Opinions

.48~~64~~ Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

Reports on Comparative Financial Statements

.49~~65~~ The report shall ~~Paragraph .04 requires that an auditor's report contain~~ either contain an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference ~~in paragraph .04~~ to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor[11]~~[22]~~ should update[12]~~[23]~~ the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.[13]~~[24]~~ Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (*See* AS 3110.01. (currently AU sec. 530))

[11]~~[22]~~ A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period. If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .49~~65~~ through .53~~69~~ and may indicate in its report or

signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .54~~70~~ through .58~~74~~ should be followed.

[12~~23~~] An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (*see* AS 3110.06 through .08), since in issuing an updated report the continuing auditor considers information that he or she has become aware of during his or her audit of the current-period financial statements (*see* paragraph .52~~68~~) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

[13~~24~~] A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report.

.50~~66~~ During the audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (*see* paragraph .52~~68~~) or the adequacy of informative disclosures concerning those statements. (*See* AS 2810.31.) In updating his or her report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his or her attention.

Different Reports on Comparative Financial Statements Presented

.51~~67~~ Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements ~~(excluding the standard introductory and scope paragraphs, where applicable)~~ with different reports on one or more financial statements presented.

~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______, long-term debt by $_______, and retained earnings by $_______ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the year then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the balance sheets of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America. Because of the matter discussed in the ~~preceding~~ following paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[14][~~25~~]

Basis for Opinion [~~Same first paragraph as the standard report~~]

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as explained ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[14]~~25~~ It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency of application of generally accepted accounting principles. *See* AS 2820 for a discussion of consistency.

Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed

.52~~68~~ If, during the current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he or she should consider such matters when updating his or her report on the financial statements of the prior period. For example, if an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.53~~69~~ If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of his or her report. The explanatory paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, and (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of ~~an explanatory~~ a paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements ~~referred to above~~

present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report. [15][~~26~~]

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[15][~~26~~] *See* footnote 6~~17~~.

Report of Predecessor Auditor

.54~~70~~ A predecessor auditor ordinarily would be in a position to reissue his or her report on the financial statements of a prior period at the request of a former client if he or she is able to make satisfactory arrangements with the former client to perform this service and if he or she performs the procedures described in paragraph .55~~71~~.[16~~27~~]

[16~~27~~] It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

Predecessor Auditor's Report Reissued

.55~~71~~ Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, a predecessor auditor should consider whether his or her previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (*a*) read the financial statements of the current period, (*b*) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (*c*) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[17~~28~~] The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in paragraphs ~~AS 1205~~.10 through .12 of AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*. However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor.

[17~~28~~] *See* AS 2805, *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter."

.56~~72~~ A predecessor auditor who has agreed to reissue his or her report may become aware of events or transactions occurring subsequent to the date of his or her previous report on the financial statements of a prior period that may affect his or her previous report (for example, the successor auditor might indicate in the response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he or she considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). The auditor should then decide, on the basis of the evidential matter obtained, whether to revise the report. If a predecessor auditor concludes that the report should be revised, he or she should follow the guidance in paragraphs .52~~68~~, .53~~69~~, and .57~~73~~ of this section.

.57~~73~~ A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are adjusted, he or she should dual-date the report. (*See* AS 3110.05.)

Predecessor Auditor's Report Not Presented

.58~~74~~ If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the ~~introductory~~ paragraph immediately following the opinion paragraph of his or her report (a) that the financial statements of the prior period were audited by another auditor,[18] ~~[29]~~ (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than an ~~standard~~ unqualified report, the substantive reasons therefor.[19] ~~[30]~~ An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheet of ABC Company (the "Company") as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes

> [*and schedules*] (collectively referred to as the "financial statements"). ~~These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~ In our opinion, the 20X2 financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.
>
> The financial statements of ~~ABC~~ the Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.
>
> Basis for Opinion
>
> [~~*Same second paragraph as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]
>
> Critical Audit Matters [if applicable]
>
> *[Include critical audit matters]*
>
> [*Signature*]
>
> We have served as the Company's auditor since [*year*].
>
> [*City and State or Country*]
>
> [*Date*]

If the predecessor auditor's report was other than an ~~standard~~ unqualified report, the successor auditor should describe the nature of and reasons for the ~~explanatory~~ paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

> . . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Opinion on the Financial Statements section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[18] ~~[29]~~ The successor auditor should not name the predecessor auditor in his or her report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

[19] ~~[30]~~ If the predecessor's report was issued before the effective date of this section and contained an uncertainties explanatory paragraph, a successor auditor's report issued or reissued after the effective date hereof should not make reference to the predecessor's previously required explanatory paragraph.

Management Reports on Internal Controls Over Financial Reporting

.59 In situations in which management is required to report on the company's internal control over financial reporting but such report is not required to be audited, and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in documents containing audited financial statements and the independent auditor's report under AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements.*

.60 In situations described in paragraph .59, the auditor must include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;
- As part of the audit, the auditor is required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and

- The auditor expresses no such opinion.

Following is an example of the Basis for Opinion section in the auditor's report that contains such statements:

> [Basis for Opinion]
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.
>
> Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Effective Date and Transition

.61~~75~~ This section is effective for reports issued or reissued on or after February 29, 1996. Earlier application of the provisions of this section is permissible.

.62~~76~~ An auditor who previously included an uncertainties explanatory paragraph in a report should not repeat that paragraph and is not required to include an emphasis paragraph related to the uncertainty in a reissuance of that report or in a report on subsequent periods' financial statements, even if the uncertainty has not been resolved. If the auditor decides to include an emphasis paragraph related to the uncertainty, the paragraph may include an explanation of the change in reporting standards.

II. Proposed Amendments to Auditing Standards

AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors*)

* * *

.07 When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ the Opinion on the Financial Statements and Basis for Opinion sections, the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.[3]

* * *

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of X Company (the "Company") and subsidiaries as of December 31, 20...., and the related consolidated statements of income and retained earnings and cash flows for the year then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit~~s~~. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate.

* * *

Other Auditor's Report Departs From ~~Standard~~ the Auditor's Unqualified Report

.15 If the report of the other auditor is other than ~~a standard~~ an auditor's unqualified report, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

Restated Financial Statements of Prior Years Following a Pooling of Interests

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have audited one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not audited a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (*see* paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has audited the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the opinion paragraph ~~standard introductory, scope and opinion paragraphs~~ covering the consolidated financial statements for the current year:*

* * *

AS 1210 (currently AU sec. 336), ***Using the Work of a Specialist***

* * *

Effect of the Specialist's Work on the Auditor's Report

.13 If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (*See* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

.14 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the assertions in the financial statements are not in conformity with GAAP. In that event, the auditor should express a qualified or adverse opinion. (*See* AS 3105~~1~~.18~~35~~, .19~~36~~, and .24~~41~~.)

Reference to the Specialist in the Auditor's Report

.15 ~~Except as discussed in paragraph .16 the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.~~ Reference to the use of a specialist may be made in the auditor's report in the following situations:

a. *Critical Audit Matters*—If such a reference will facilitate an understanding of the matter, the principal considerations that led the auditor to determine that the matter was a critical audit matter, or how the critical audit matter was addressed in the audit;[7] or

b. *Explanatory language or departure from an unqualified opinion*—If such a reference will facilitate an understanding of the reason for the explanatory paragraph or departure from an unqualified opinion.

Otherwise the auditor should not refer to the work or findings of the specialist in the auditor's report.

[7] Critical audit matters are described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~.16 The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.~~

* * *

AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*

* * *

.10 In an audit, the engagement quality reviewer should:

* * *

j. Based on the procedures required by this standard, evaluate the engagement team's determination, communication, and documentation of critical audit matters in accordance with AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

* * *

AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees*

* * *

~~Departure from the Auditor's Standard Report~~ The Auditor's Report

.21 The auditor should ~~communicate~~ provide to and discuss with the audit committee ~~the following matters related to~~ a draft of the auditor's report~~:~~.

~~a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~

b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

* * *

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

[39] *See* paragraphs .05~~22~~-.15~~32~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances,* for a discussion of scope limitations.

* * *

AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

* * *

Reporting on Internal Control

.85 The auditor's report on the audit of internal control over financial reporting ~~must~~ includes the following elements[18] -

Title

.85A The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

Addressee

.85B The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

Opinion on the Internal Control over Financial Reporting

.85C The first section of the auditor's report on the audit of internal control over financial reporting must include the section title "Opinion on Internal Control over Financial Reporting" and the following elements-

~~a. A title that includes the word *independent*;~~

a. The name of the company whose internal control over financial reporting was audited; and

b. ~~k.~~ The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria.

Basis for Opinion

.85D The second section of the auditor's report on the audit of internal control over financial reporting must include the section title "Basis for Opinion" and the following elements:

a~~b~~. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

b~~c~~. An identification of management's report on internal control;

c~~d~~. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

d~~e~~. A definition of internal control over financial reporting as stated in paragraph .A5;

e. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;

f. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~;

g. A statement that the standards of the PCAOB ~~Public Company Accounting Oversight Board~~ require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion; and

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Signature, Tenure, Location, and Date

.85E The auditor's report must include the following elements:

a~~l~~. The ~~manual or printed~~ signature of the auditor's firm;[18A]

b. A statement containing the year the auditor began serving consecutively as the company's auditor;

> Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

c~~m~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

d~~n~~. The date of the audit report.

[18A] *See* Regulation S-X Rule 2-02(a).

* * *

.87 The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of W Company

[~~*Introductory paragraph*~~] *Opinions on the Financial Statements and Internal Control over Financial Reporting*

We have audited the accompanying balance sheets of W Company (the "Company") as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). We also have audited ~~W~~ the Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ~~W~~ the Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, ~~W~~ the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by ~~the Committee of Sponsoring Organizations of the Treadway Commission (COSO~~)."*].

Basis for Opinion

~~[*Scope paragraph*]~~

~~W~~ The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the ~~c~~Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements.~~,~~ Our audits also included evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, ~~and~~ as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters [if applicable]

[Include critical audit matters]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.88 If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (immediately following the opinion paragraph) to the auditor's report on the financial statements –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph (immediately following the opinion paragraph) to the report on internal control over financial reporting –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the [*identify financial statements*] of the Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

* * *

.B16 In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis for Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*). If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

* * *

.C4 When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph .85D g, h, and i); to do so might overshadow the disclaimer.

* * *

AS 2405 (currently AU sec. 317), *Illegal Acts by Clients*

* * *

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.[2]

[2] *See* AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

AS 2410 (currently Auditing Standard No. 18), *Related Parties*

* * *

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

.18 If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.[20]

[20] *See* AS 2805.06l, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. *See also* paragraphs .18~~35~~–.19~~36~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (currently AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*)

* * *

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

* * *

c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to reflect that conclusion.[4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13.

[4] The inclusion of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (*see* paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (*see* paragraphs .44-.47 of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

.13 An example follows of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.[5]

[*Appropriate Title*]

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in AS 3105~~1,~~ ~~*Reports on Audited Financial Statements*~~.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in AS 3105~~1~~.

* * *

AS 2503 (currently AU sec. 332), *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

* * *

.32 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph, including an appropriate title, should be added to the auditor's report because of the change in reporting period.[15]

[15] ~~*See* paragraphs .16–.18 of AS 3101, *Reports on Audited Financial Statements*~~ AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements.*

* * *

AS 2505 (currently AU sec. 337), *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*

* * *

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (*see* paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion (*see* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (*see* paragraph .09*g*). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in AS 3105~~1~~.28~~45~~ through .32~~49~~ to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

AS 2510, *Auditing Inventories* (currently AU sec. 331, *Inventories*)

* * *

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see paragraphs .07~~24~~ and .51~~67~~ of AS

310~~5~~1, *~~Reports on Audited Financial Statements~~ Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors,* (currently AU sec. 315, *Communications Between Predecessor and Successor Auditors*)

* * *

[9] *See* paragraphs .54~~70~~ through .58~~74~~ of AS 3105~~1~~, *~~Reports on Audited Financial Statements~~ Departures from Unqualified Opinions and Other Reporting Circumstances*, for reporting guidance.

* * *

AS 2705 (currently AU sec. 558), *Required Supplementary Information*

* * *

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph, including an appropriate title, in his report on the audited financial statements a disclaimer on the information. The following is an example of a disclaimer an auditor might use in these circumstances:

> [*Appropriate Title*]
>
> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

* * *

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in any of the following circumstances:[7] (*a*) the supplementary information that GAAP requires to be presented in the circumstances is omitted; (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (*c*) the auditor is unable to complete the prescribed procedures; (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs<u>, including appropriate titles,</u> an auditor might use in these circumstances.

* * *

AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements*

* * *

.04 Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[2] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph<u>, including an appropriate title,</u> describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

* * *

AS 2801 (currently AU sec. 560), *Subsequent Events*

* * *

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an ~~explanatory~~ emphasis paragraph directing the reader's attention to the event and its effects. (*See* paragraph .19 of AS 3101, ~~*Reports on Audited Financial Statements*, ~~*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*)

* * *

AS 2805 (currently AU sec. 333), *Management Representations*

* * *

[15] *See* paragraph .55~~71~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[18] *See* AS 3105~~1~~.05~~22~~ ~~–~~.17~~34~~.

* * *

AS 2810 (currently Auditing Standard No. 14), *Evaluating Audit Results*

* * *

[7] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

.31

* * *

Note: According to AS 3105~~1~~, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18]

[18] AS 3105~~1~~.24~~41~~–.27~~44~~.

* * *

.35 If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AS 3105~~1~~ indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[21]

[21] AS 3105~~1~~.05~~22~~–.17~~34~~ contains requirements regarding audit scope limitations.

* * *

Appendix B

[1] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

Appendix C

[2] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (*See* AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

* * *

AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"* (currently AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*)

.01 An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the applicable financial reporting framework ~~country of origin of those generally accepted accounting principles also~~ is required (*see* ~~paragraph .08*h* of AS 3101~~paragraph .08e of the AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

* * *

[1] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (*see* AS 2105 (currently Auditing Standard No. 11), *Consideration of Materiality in Planning and Performing an Audit*, and AS 3105~~1~~.19~~36~~).

* * *

AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*

* * *

.06 The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.[5] In addition, the auditor should recognize a change in the reporting entity[6] by including an explanatory paragraph, including an appropriate title, in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

* * *

.08 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph .07 have been met, the auditor should add an explanatory paragraph, including an appropriate title, to the auditor's report, as described in ~~AS 3101, *Reports on Audited Financial Statements*~~ paragraphs .12-.15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AS 3101~~.[8A]

> Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to the auditor's report, as described in ~~AS 3101~~ paragraphs .12-.15.

[8A] AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.09 The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title, as described in ~~AS 3101~~ paragraphs .16 and.17 of this standard.

.10 The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph .31 of AS 2810, *Evaluating Audit Results,* and AS 3105~~1~~, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

Change in Classification

.11 Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs .07,~~, and~~ .08, and ~~AS 3101~~ .12-.15. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs .09,~~, and~~ .10, ~~and~~ ~~AS 3101~~ .16 and.17.

Reporting on Consistency of Financial Statements

Change in Accounting Principle

.12 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph). The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

.13 The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has changed its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.14 The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has elected to change its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*].

.15 The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

Correction of a Material Misstatement in Previously Issued Financial Statements

.16 Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph).[10] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. The following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[10] AS 3105.52-53 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.17 This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

*** * ***

AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report*

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, *see* AS 4101 as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and *see* paragraphs .54~~70-~~.57~~73~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the predecessor auditor's responsibility when reissuing or consenting to the reuse of a report previously issued on the financial statements of a prior period.

*** * ***

AS 3305 (currently AU sec. 623), *Special Reports*

.01 This section applies to auditors' reports issued in connection with the following:

*** * ***

e. Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports (paragraphs .32 and .33)

Note: In situations in which the auditor's reports described in this section are filed with the U.S. Securities and Exchange Commission, the auditor's report is required to include the basic elements and communication of critical audit matters, if applicable, as would be required in an unqualified auditor's reporting under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For qualified, adverse, and disclaimer of opinion reports, see requirements of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[2] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

* * *

.06 Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report ~~use the standard form of report (*see* paragraph .08 of AS 3101, Reports on Audited Financial Statements) modified as appropriate~~ because of the departures from generally accepted accounting principles (*see* AS 3105).

* * *

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. ~~With the exception of the requirement in AS 3101.08*h*, t~~The standards of the PCAOB are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. ~~AS 3101.08*h*, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when~~ If the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles, the auditor's opinions, as described in AS 3101 and AS 3105, are applicable.

* * *

.14 The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (*see* AS 3105~~1~~.48~~64~~). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement

.15 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

*** * ***

b. A paragraph that—

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

* * *

.17 The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in AS 3101.18~~1~~, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

* * *

.21 When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph~~ in the Opinion on the Financial Statements section, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

* * *

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

a. *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,[35] the auditor should add an explanatory paragraph, including an appropriate title, to the report (immediately following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon [36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~AS 3101.16 through .18~~ AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*.

b. *Going Concern* Uncertainties. If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph, including an appropriate title, after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.[39]

c. *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in ~~section AS 3101.12 and .13~~ AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec, 543, *Part of Audit Performed by Other Independent Auditors*).

d. Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof). If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph

~~preceding~~ immediately following the opinion paragraph of the report. Guidance on reporting in this situation is contained in AS 3105~~1~~.52~~68~~ and .53~~69~~.

* * *

AS 3310, *Special Reports on Regulated Companies* (currently AU sec. 544, *Lack of Conformity With Generally Accepted Accounting Principles*)

* * *

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (For example, public utilities and insurance companies.) Accordingly, the requirement in paragraph .08e~~*h*~~ of AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated.[1] Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

* * *

.04 When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (*see* AS 3101.08), modified~~ modify the auditor's report as appropriate (*see* paragraphs .18-.43 of AS 3105~~1.35–.60~~, *Departures from Unqualified Opinions and Other Reporting Circumstances*) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting.

* * *

AS 3315 (currently AU sec. 552), *Reporting on Condensed Financial Statement and Selected Financial Data*

* * *

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in paragraphs .24~~41~~ through .27~~44~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, AS 3305, *Special Reports*, or other applicable PCAOB standards.[2]

* * *

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Report of Independent Registered Public Accounting Firm

> We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency), ~~6~~ the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.[7]

~~6 If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (*See* AS 3101.41 through .44) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Report of Independent Registered Public Accounting Firm.~~

> ~~We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with~~

~~accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended. [Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

.10 The following is an example of an additional paragraph included in the Opinion on the Financial Statements section of the auditor's report ~~that includes an additional paragraph~~ because ~~he~~ the auditor is also engaged to report on selected financial data for a five-year period ended December 31, ~~19~~20X5, in a client-prepared document that includes audited financial statements:

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.~~

Opinion on the Financial Statements

[Includes the same basic elements in the Opinion on the Financial Statements section as the auditor's unqualified report in AS 3101]

In our opinion, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of the ~~ABC~~ the Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended

December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1, and the related notes [*and schedules*] (collectively referred to as the "financial statements") (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

* * *

AS 3320 (currently AU sec. 504), *Association with Financial Statements*

* * *

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and AS 31051~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in AS 4105, *Reviews of Interim Financial Information*.

* * *

AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes* (currently AU sec. 711, *Filings Under Federal Securities Statutes*)

* * *

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their audits of the financial statements for different periods. An auditor who has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

a. Read pertinent portions of the prospectus and of the registration statement.

b. Obtain a letter of representation from the successor independent auditor regarding whether his audit (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (*see* AS 3105~~1~~, ~~Reports on Audited Financial Statements~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

* * *

AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*)

* * *

Form of Accountant's Review Report

* * *

.37 The accountant's review report accompanying interim financial information ~~should consist of~~ must include the title, "Report of Independent Registered Public Accounting Firm."

.37A The accountant's review report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The accountant's review report may include additional addressees.

.37B The first section of the accountant's review report must include the section title "Results of Review of [Financial Information or Statements]" and the following elements:

~~a. A title that includes the word independent.~~

a. The name of the company whose interim financial information was reviewed.

b. A statement that the interim financial information identified in the report was reviewed.

c~~g~~. A statement about whether the accountant is aware of any material modifications that should be made to the accompanying interim financial information for it to conform with generally accepted accounting principles. The statement should include an identification of the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).

.37C The second section of the accountant's review report must include the section title "Basis for Review Results" and the following elements:

a~~c~~. A statement that the interim financial information is the responsibility of the entity's management.

b~~d~~. A statement that the review of interim financial information was conducted in accordance with the standards of the PCAOB.

c~~e~~. A description of the procedures for a review of interim financial information.

d~~f~~. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

.37D The accountant's review report must include the following elements:

a~~h~~. The ~~manual or printed~~ signature of the accountant's firm.[24A]

b~~i~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.[24~~A~~B]

c~~j~~. The date of the review report. (Generally, the report should be dated as of the date of completion of the review procedures.[25])

In addition, each page of the interim financial information should be clearly marked as unaudited.

[24A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

[24~~A~~B] *Id.*~~*See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

.38 The following is an example of a review report:[26]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

Basis for Review Results

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q. [27]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of [*Financial Information or Statements*]

We have reviewed the condensed consolidated balance sheet of ABC Company (the "Company") and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of ~~ABC~~ the Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.[28]

Basis for Review Results

These financial statements are the responsibility of the Company's management. We conducted our review in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

[28] If the auditor's report on the preceding year-end financial statements was other than unqualified, referred to other auditors, or included an explanatory paragraph because of a going-concern matter or an inconsistency in the application of accounting principles, the ~~last~~ second paragraph of the illustrative report in paragraph .39 should be appropriately modified.

.40 The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review.[29] The following is an example of report including such a reference:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

Basis for Review Results

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.41 The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles,~~[30]~~ which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. *See* paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~[30] If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in paragraph .15 of AS 3101, Reports on Audited Financial Statements.~~

.42 *Departure from generally accepted accounting principles.* If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he or she should modify the report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. Following is an example of such a modification of the accountant's report.

~~[*Concluding paragraph*]~~

Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

~~[*Explanatory third paragraph*]~~

Based on information furnished to us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that we believe should be capitalized to conform with accounting principles generally accepted in the United States of America. This information indicates that if these lease obligations were capitalized at September 30, 20X1, property would be increased by $______, long-term debt by $______, and net income and earnings per share would be increased (decreased) by $________, $_________, $________, and $________, respectively, for the three-month and nine-month periods then ended.

* * *

.43 *Inadequate disclosure*. The information necessary for adequate disclosure is influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30, which is applicable to summarized financial statements of public companies, are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.[31] If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles[32] is not included in the interim financial information, the accountant should modify the report and, if practicable, include the necessary information in the report. The following is an example of such a modification of the accountant's report:

> ~~[*Concluding paragraph*]~~
>
> Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.
>
> ~~[*Explanatory third paragraph*]~~
>
> Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 20X1 through 20X3 in the aggregate amount of approximately $_____, and that the extent of the company's liability, if any, and the effect on the accompanying information (statements) is not determinable at this time. The information (statements) fail(s) to disclose these matters, which we believe are required to be disclosed in conformity with accounting principles generally accepted in the United States of America.

.44 *Going-concern paragraph was included in the prior year's audit report; conditions giving rise to the paragraph continue to exist.* If (*a*) the auditor's report for the prior year end contained an explanatory paragraph indicating the existence of substantial doubt about the entity's ability to continue as a going concern, (*b*) the conditions that raised such doubt continued to exist as of the interim reporting date covered by the review, and (*c*) there is adequate and appropriate disclosure about these conditions in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report~~, after the concluding paragraph,~~ emphasizing the matter disclosed in the audited financial statements and the interim financial information. The following is an example of such a paragraph.

> [Appropriate Title]
>
> Note 4 of the Company's audited financial statements as of December 31, 20X1, and for the year then ended discloses that the Company was unable to renew its line of credit or obtain alternative financing at December 31, 20X1. Our auditor's report on those financial statements includes an explanatory paragraph referring to the matters in Note 4 of those financial statements and indicating that these

matters raised substantial doubt about the Company's ability to continue as a going concern. As indicated in Note 3 of the Company's unaudited interim financial statements as of March 31, 20X2, and for the three months then ended, the Company was still unable to renew its line of credit or obtain alternative financing as of March 31, 20X2. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

.45 *Going-concern paragraph was not included in the prior year's audit report; conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern.* If (*a*) conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern, and (*b*) there is adequate and appropriate disclosure about these conditions or events in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report~~, after the concluding paragraph,~~ emphasizing the matter disclosed in the interim financial information. The following is an example of such a paragraph.

<u>[Appropriate Title]</u>

As indicated in Note 3, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

* * *

.50 The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

* * *

c. The selected quarterly financial data required by item 302(a) of Regulation S-K is omitted. <u>The auditor should add an explanatory paragraph, including an appropriate title, to the report, immediately following the opinion paragraph,</u> ~~The following is an~~

~~example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) is omitted. The following is an example of such a paragraph.

[Appropriate Title]

The company has not presented the selected quarterly financial data specified in item 302(a) of Regulation S-K that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The auditor should add an explanatory paragraph, including an appropriate title, to the report immediately following the opinion paragraph, ~~The following is an example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) has not been reviewed. The following is an example of such a paragraph.

[Appropriate Title]

The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

* * *

AS 6101 (currently AU sec. 634), *Letters for Underwriters and Certain Other Requesting Parties*

* * *

.27 When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements, ~~for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report,~~ the accountants should refer[18] to that fact in the comfort letter and discuss the subject matter of the paragraph.[19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (*See also* paragraph .35*f*.)

* * *

.30 An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which AS 4105 pertains or (*b*) required supplementary information, to which AS 2705 pertains. AS 4105 and AS 2705 provide that the accountants should expand the ~~standard~~ auditor's unqualified report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ auditor's unqualified report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (*see also* paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by AS 4105 and AS 2705, the accountants may do so and report their findings.

* * *

.35

* * *

f. When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ unqualified report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

* * *

III. Proposed Amendments to Auditing Interpretations

AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210* (currently AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*)

* * *

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer.[14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with paragraphs .18~~35~~ through .43~~60~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with AS 3105~~1~~.05~~22~~–.09~~26~~ and AS 3105~~1~~.44~~61~~–.47~~63~~.

* * *

AI 16, *Auditing Accounting Estimates: Auditing Interpretations of AS 2501* (currently AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*)

* * *

.03 *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an emphasis-of-matter paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (*see* paragraph .19 of AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

* * *

AI 17, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505 (currently AU sec. 9337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337*)

* * *

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in paragraphs .28~~45~~ through .32~~49~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

AI 23, ~~Reports on Audited Financial Statements: Auditing Interpretations of AS 3101~~ Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of AS 3105~~1~~ (currently AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*)

* * *

.01 *Question*— Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

* * *

.36 ~~Examples of~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report~~s~~ on single year financial statements in the year of adoption of liquidation basis follows:[1A] ~~with such an explanatory paragraph follow.~~

> ~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~
>
> Opinion on the Financial Statements
>
> ~~"~~We have audited the statement of net assets in liquidation of XYZ Company (the "Company") as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2~~.~~, ~~In addition, we have~~ and audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the net assets in liquidation of ~~XYZ~~ the Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below. ~~in the preceding paragraph."~~
>
> ~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.
>
> Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audit included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit provides a reasonable basis for our opinion.

[1A] The auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows:[1B]

Opinion on the Financial Statements

~~"~~We have audited the balance sheet of XYZ Company (the "Company") as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and~~. In addition, we have~~ audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~XYZ~~ the Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below.~~ in the preceding paragraph."~~

~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audits included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[1B] *Id.*

* * *

12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report

.51 *Question*—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

.52 *Interpretation*—No. The statement about management's responsibilities for the financial statements required by AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard~~ unqualified report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

* * *

14. Reporting on Audits Conducted in Accordance with the Standards of the PCAOB and in Accordance with International Standards on Auditing

* * *

.56 *Question*—AS 3101 requires ~~states that a basic element of the auditor's report is~~ a statement that the audit was conducted in accordance with the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~. If the auditor conducts the audit in accordance with the standards of the PCAOB and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board ~~Practices Committee~~ of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

.57 *Interpretation*—Yes. AS 3101 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with the standards of the PCAOB ~~and an~~

~~identification of the United States of America as the country of origin of those standards~~; however, AS 3101 does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.

* * *

.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing follows:

> Basis for Opinion
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~ and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. ~~An~~ Our audit included~~s~~ performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

* * *

.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to AS 3105~~1~~.58~~74~~ the successor auditor should indicate in the ~~introductory paragraph~~ Opinion on the Financial Statements section of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 18~~29~~ of AS 3105~~1~~ indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Opinion on the Financial Statements section of the successor auditor's report is presented as follows:

> The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor’s report.

* * *

.63 When the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. (The auditor also may use the guidance on alternative language contained in paragraph .71, below.) In determining the nature, timing and extent of procedures, the successor auditor should consider that a predecessor auditor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

* * *

.71 If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. Alternatively, the successor auditor may wish to make it clear that he or she did not audit, review, or apply other procedures to the prior-period financial statements beyond the procedures applied to the restatement adjustments. Accordingly, he or she may include the following paragraph in his or her report:

* * *

.74 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations have been subsequently restated, but the successor auditor has not yet completed an audit of current-period financial statements, can the successor auditor report on the restatement adjustments pursuant to 3105~~1~~.58~~74~~?

.75 *Interpretation*—No. AS 3105~~1~~.58~~74~~ is only applicable when the prior-period financial statements are presented for comparative purposes with current-period audited financial statements. If the prior-period financial statements have been restated, and the successor auditor is requested to report on those financial statements without also reporting on current-period audited financial statements, the successor auditor would need to reaudit the prior-period financial statements in order to report on them.

* * *

AI 20: *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710* (currently AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*)

* * *

.08 *Interpretation*—If the auditor has been engaged to ~~examine and report on management's assertion, the guidance in AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, should be followed~~ perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should follow the requirement of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

.09 If the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting ~~examine and~~

~~report on management's assertion~~, the auditor should follow the requirements in AS 3105.59-60. ~~guidance in AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact.[5]~~

~~[5] Unless information on internal control over financial reporting appears in the financial statements, which is not common, a management assertion on the effectiveness of internal control over financial reporting could not be inconsistent with information appearing in financial statements.~~

~~.10 Although not required, the auditor may consider adding the following paragraph to the standard auditor's report: "We were not engaged to examine management's assertion about the effectiveness of [*name of entity's*] internal control over financial reporting as of [*date*] included in the accompanying [*title of management's report*] and, accordingly, we do not express an opinion thereon."~~

~~.11 Because an auditor is required to consider internal control in an audit of the financial statements, he or she would often be familiar with matters covered in a management report on internal control over financial reporting. As a result, the auditor may become aware of information that causes him or her to believe that management's assertion on the effectiveness of internal control over financial reporting contains a material misstatement of fact as described in AS 2710.[6] If the auditor becomes aware of information in the report by management that conflicts with his or her knowledge or understanding of such matters, he or she should discuss the information with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists, the auditor should follow the guidance in AS 2710.06.~~

~~[6] For example, the auditor has communicated to management a material weakness in internal control over financial reporting and management states or implies there are no material weaknesses.~~

* * *

AI 24, *Special Reports: Auditing Interpretations of AS 3305* (currently AU sec. 9623, *Special Reports: Auditing Interpretations of Section 623*)

* * *

[10] Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

.83 *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in AS 3105~~1~~.18~~35 –~~.27~~44~~ and .40~~58 –~~.43~~60~~.

* * *

.86 If there is no such agreement, the auditor should follow the guidance in AS 3105~~1~~.18~~35 –~~.27~~44~~ and .40~~58 –~~.43~~60~~.

* * *

***AI 25, Association with Financial Statements: Auditing Interpretations of AS 3320* (currently AU sec. 9504, *Association With Financial Statements: Auditing Interpretations of Section 504*)**

* * *

.15 *Question*—Paragraph .01~~.04~~ of ~~AS 3101, *Reports on Audited Financial Statements*,~~ AS 3320, *Association with Financial Statements*, states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." ~~Paragraph .03 of~~ AS 3320.03~~, Association with Financial Statements,~~ states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

* * *

AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations* (currently AU sec. 9326, *Evidential Matter: Auditing Interpretations of Section 326*)

* * *

.10 Auditing standards require the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph .35 of AS 2810, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, AS 2805, *Management Representations,* requires the auditor to obtain written representations from management. AS 2805.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and AS 2805.08 states that a materiality limit does not apply to that representation. AS 2805.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

* * *

APPENDIX 3

Characteristics of Self-Identified EGCs

The PCAOB has been monitoring implementation of the Jumpstart Our Business Startups Act ("JOBS Act") in order to understand the characteristics of EGCs[1] and inform the Board's consideration of whether it should request that the SEC apply the reproposed standards and related amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.[2]

As of November 15, 2015, based on the PCAOB's research, there were 2,229 companies that had filed audited financial statements and identified

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[1] Pursuant to the JOBS Act, an EGC is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than $1 billion during its most recently completed fiscal year and its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 ("Securities Act") did not occur on or before December 8, 2011. *See* JOBS Act Section 101(a), (b), and (d). An issuer retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of $1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than $1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least $700 million).

[2] The staff of the PCAOB's Office of Research and Analysis identified the population of EGCs using Audit Analytics data on companies that, as of the calculation date, self-identified as EGCs in SEC filings. The data excludes companies that, as of the calculation date, had (i) terminated their Exchange Act registration, (ii) had their Exchange Act registration revoked, or (iii) withdrawn their registration statement before effectiveness and, in each case, did not subsequently file audited financial statements with the SEC. It also excludes companies that reported more than $1 billion in annual revenues or self-identified as a large accelerated filer. PCAOB staff has not otherwise attempted to validate these companies' self-identification as EGCs.

themselves as EGCs in at least one SEC filing. Among the 2,229 EGCs, there were 259 that did not file audited financial statements within the 18 months preceding November 15, 2015.[3] Because of lack of current data regarding these 259 companies, the information below focuses on the remaining 1,970 companies that filed audited financial statements with the SEC in the 18 months preceding November 15, 2015.

General Characteristics

These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are: (i) pharmaceutical preparations; (ii) blank check companies; (iii) real estate investment trusts; (iv) prepackaged software services; and (v) computer processing and data preparation.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are codes for: (i) real estate investment trusts; (ii) state commercial banks; (iii) crude petroleum or natural gas; (iv) national commercial banks; and (v) pharmaceutical preparations. Total assets of EGCs in these five SIC codes represent approximately 45 percent of the total assets of the population of EGCs. EGCs in two of these five SIC codes (state commercial banks and national commercial banks) represent financial institutions, and the total assets for these two SIC codes represent approximately 17 percent of the total assets of the population of EGCs.

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[3] Approximately 24 percent of these 259 companies are blank check companies according to the Standard Industrial Classification (“SIC”) code. This is the most common SIC code among the 259 companies; the next most common SIC code (6 percent) is that for metal mining. The remaining SIC codes each represent less than 5 percent. Approximately 80 percent of these 259 companies had an explanatory paragraph included in the last auditor's report filed with the SEC stating that there is substantial doubt about the company's ability to continue as a going concern. Approximately 10 percent of these 259 companies were audited by firms that were annually inspected firms in 2015 and 90 percent of these 259 companies were audited by firms that are subject to inspection at least every three years by the PCAOB, containing U.S. firms (85 percent), firms that are non-U.S. affiliates of annually inspected firms in 2015 (3 percent), and other non-U.S. firms (2 percent).

Approximately 14 percent of the EGCs had identified themselves in Securities Act registration statements and had not reported under the Exchange Act as of November 15, 2015. Approximately 74 percent of EGCs began reporting under the Exchange Act in 2012 or later. The remaining 12 percent of these companies have been reporting under the Exchange Act since 2011 or earlier.

Approximately 56 percent of EGCs that filed an Exchange Act filing indicated that they were smaller reporting companies.[4]

Approximately 41 percent (802) of the 1,970 EGCs have common equity securities listed on a U.S. national securities exchange ("publicly listed EGCs").[5] These EGCs represent approximately 16 percent of all publicly listed companies and approximately 1 percent of the total market capitalization of publicly listed companies.

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[4] The SEC adopted its current smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 33-8876 (December 19, 2007). Generally, companies qualify to be smaller reporting companies and, therefore, have scaled disclosure requirements if they have less than $75 million in public equity float. Companies without a calculable public equity float will qualify if their annual revenues were less than $50 million during the most recently completed fiscal year for which audited financial statements are available. Scaled disclosure requirements generally reduce the compliance burden of smaller reporting companies compared to other issuers.

[5] To compare the publicly-listed EGC population with the broader public equity market, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with a benchmark derived from data from Standard & Poor's on companies that have at least one class of common equity securities (common-ordinaries, units with a common share component, and depository receipts) listed on a U.S. national securities exchange. The benchmark population is limited to companies that are not investment companies and that, according to Audit Analytics data, have filed audited financial statements with the SEC in the 18 months preceding the calculation date. From a total population of 5,119 such companies, the 802 publicly listed EGCs are excluded to avoid double counting. Using this methodology, PCAOB staff identified 4,317 companies in the benchmark population (referred to as "other publicly listed companies") as of November 15, 2015.

Financial Data

The information in this section is derived from the most recent audited financial statements filed as of November 15, 2015 for the 1,970 EGCs. The descriptions in this section also include tabular information for all EGCs, EGCs that are not publicly listed ("non-listed EGCs"), and publicly listed EGCs. To enable comparison of publicly listed EGCs with the broader public equity market, the information also includes data about the other publicly listed companies.

Assets. The reported assets of all EGCs ranged from zero to approximately $12.9 billion. The average and median reported assets were approximately $223 million and $3.4 million, respectively. Publicly listed EGCs had significantly higher average and median assets (approximately $468 million and $141 million, respectively) as compared to non-listed EGCs (approximately $55 million and $100,000, respectively). Other publicly listed companies had even higher average and median assets (approximately $ 18.5 billion and $1.3 billion, respectively).

Reported Assets ($ millions)	All EGCs	Non-listed EGCs	Publicly Listed EGCs	Other Publicly Listed Companies
Minimum	0.0	0.0	0.0	0.0
Maximum	12,859.4	12,859.4	9,798.7	2,634,139.0
Average	223.0	54.6	468.3	18,486.8
Median	3.4	0.1	141.4	1,299.2

Revenues. The reported revenues ranged from zero to approximately $926 million. The average and median reported revenue were approximately $55 million and $81,000, respectively. Publicly listed EGCs had significantly higher average and median revenues (approximately $118 million and $33 million, respectively) as compared to non-listed EGCs (approximately $12 million and $0, respectively). Other publicly listed companies had even higher average and median revenues (approximately $5.1 billion and $580 million, respectively).

Reported Revenues ($ millions)	All EGCs	Non-listed EGCs	Publicly Listed EGCs	Other Publicly Listed Companies
Minimum	0.0	0.0	0.0	0.0
Maximum	926.4	910.2	926.4	485,651.0
Average	54.9	11.5	118.2	5,124.2
Median	0.081	0.0	33.2	579.6

Companies Reporting Zero Revenues. The table below provides information about the percentage of all EGCs and the other categories of companies that reported zero revenues.

	All EGCs	**Non-listed EGCs**	**Publicly Listed EGCs**	**Other Publicly Listed Companies**
Companies Reporting Zero Revenues	42%	56%	21%	2%

Companies Reporting Revenues Greater than Zero. The table below provides information about the percentage of all EGCs and the other categories of companies that reported revenues greater than zero.

	All EGCs	**Non-listed EGCs**	**Publicly Listed EGCs**	**Other Publicly Listed Companies**
Companies Reporting Revenues Greater than Zero	58%	44%	79%	98%

The average reported assets and revenues of EGCs that reported revenues greater than zero were approximately $371 million and $94 million, respectively. Publicly listed EGCs had significantly higher average assets and revenues (approximately $573 million and $149 million, respectively) as compared to non-listed EGCs (approximately $121 million and $26 million, respectively). Other publicly listed companies had even higher average assets and revenues (approximately $18.9 billion and $5.2 billion, respectively).

Reported Assets and Revenues ($ millions)	**All EGCs**	**Non-listed EGCs**	**Publicly Listed EGCs**	**Other Publicly Listed Companies**
Assets				
Minimum	0	0	0	0
Maximum	12,859.4	12,859.4	9,798.7	2,634,139.0
Average	370.8	121.4	573.3	18,889.6
Median	71.0	1.1	200.8	1,371.7

Revenues				
Minimum	0.00002	0.00002	0.00391	0.002
Maximum	926.4	910.2	926.4	485,651.0
Average	93.9	25.9	149.0	5,237.0
Median	12.7	0.5	67.2	602.9

Going Concern Reporting

The table below provides information about the percentage of all EGCs and the other categories of companies that had an explanatory paragraph included in the auditor's report on their most recent audited financial statements stating that there is substantial doubt about the company's ability to continue as a going concern.

	All EGCs	**Non-listed EGCs**	**Publicly Listed EGCs**	**Other Publicly Listed Companies**
Companies With Going Concern Paragraph	49%	76%	9%	3%

Management Reporting on ICFR

Generally, EGC management is required to report on the effectiveness of internal control over financial reporting ("ICFR"), although auditor attestation is not required.[6] Approximately 50 percent of the 1,970 EGC companies provided a management report on ICFR. Of those companies that provided a management report, approximately 53 percent stated in the report that the company's ICFR was not effective. Publicly listed EGCs reported material weaknesses at a significantly lower rate (14 percent) as compared to non-listed EGCs (71

[6] The management report on ICFR is required in annual reports, starting with the second annual report filed by the company. *See* Instruction 1 to Item 308(a) of Regulation S-K. EGCs that have not yet filed at least one annual report are therefore not required to provide it. EGCs are exempt from the requirement for auditor attestation of ICFR. *See* Section 404(b) of the Sarbanes-Oxley Act.

percent). Other publicly listed companies reported material weaknesses at an even lower rate (7 percent).

ICFR Reporting	**All EGCs**	**Non-listed EGCs**	**Publicly Listed EGCs**	**Other Publicly Listed Companies**
Number of Companies	1,970	1,168	802	4,317
Companies with Management ICFR Report	993 (50%)	680 (58%)	313 (39%)	4,157 (96%)
Material Weakness in ICFR Noted by Management	525 (53%)	480 (71%)	45 (14%)	284 (7%)

Auditors

Approximately 39 percent of EGCs were audited by firms that were annually inspected in 2015 and 61 percent of EGCs were audited by firms that are subject to inspection at least every three years by the PCAOB, containing U.S. firms (48 percent), firms that are non-U.S. affiliates of annually inspected firms in 2015 (9 percent), other non-U.S. firms (4 percent).