PCAOB
Public Company Accounting Oversight Board

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STANDING ADVISORY GROUP MEETING

AUDITOR'S REPORTING MODEL

FEBRUARY 16, 2005

Introduction

At previous meetings of the Standing Advisory Group ("SAG"), some members have suggested that the auditor reporting model should be changed from the current "pass/fail" reporting model. This paper discusses the current auditor reporting model and seeks feedback on whether and, if so, how the model should be changed. In addition, this paper seeks feedback on whether the individual auditor should be identified in the audit report, whether reference to the use of other auditors should be expanded, and whether the reporting model should be revised to incorporate international reporting developments.

Current Reporting Model

The interim auditing standards of the Public Company Accounting Oversight Board ("PCAOB") are organized around a framework of ten general, field work, and reporting standards (the "ten standards"). Of the ten standards, the standards relating to reporting are as follows:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles ("GAAP").

2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

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3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall contain either 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 therefore 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.

AU section 508,[1/] *Reports on Audited Financial Statements*, provides direction to auditors in connection with audits of financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. The auditor's standard report identifies the financial statements audited in an opening paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. Appendix A to this paper presents the basic elements of the report, including an illustrative example.

AU section 508 describes the following types of reports the auditor may issue in connection with an audit of financial statements:

- *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 conforming with GAAP. This type of opinion is referred to as 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

[1/] References to AU sections throughout this paper are to the PCAOB's interim standards adopted as in existence on April 16, 2003, except as superseded or amended by the PCAOB. These standards may be found on the PCAOB's website at www.pcaobus.org.

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present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP.

- *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 GAAP.

- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

Although AU section 508 provides for different types of audit reports, SEC Staff Accounting Bulletin, "Topic 1E – Requirements for Audited or Certified Financial Statements" [Interpretive response to question 2] states:

> The staff does not accept as consistent with the requirements of Rule 2-02(b) of Regulation S-X financial statements on which the auditors' opinions are qualified because of a limitation on the scope of the audit, since in these situations the auditor was unable to perform all the procedures required by professional standards to support the expression of an opinion… Financial statements for which the auditors' opinions contain qualifications relating to the acceptability of accounting principles used or the completeness of disclosures made are also unacceptable.

Accordingly, auditor reports filed with the SEC must include unqualified opinions.

Some consider the current auditor's reporting model to be a "pass/fail" model, because an auditor's opinion states that a Company's financial statements are either presented fairly (pass) or not (fail). For example, a report with an unqualified opinion states the following:

> In our opinion, the financial statements 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.

Discussion Questions –

1. What are the advantages and disadvantages of the current auditor reporting model?

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2. Is there a need for a different form of auditor reporting other than the current "pass/fail" model? If yes, explain how that need can be best addressed.

Some believe that the auditor's reporting model should contain more information pertaining to the quality of the financial statements, possibly incorporating elements of certain communications the auditor currently is required to have with an audit client's audit committee. For example, paragraph .11 of AU section 380, *Communications with Audit Committees,* requires the auditor to discuss with the audit committee the auditor's judgments about the quality of a company's accounting principles. The auditor should discuss his or her judgments about the quality, not just the acceptability, of the company's accounting principles. Such discussion should be open and frank and generally should include matters such as the consistency of the company's accounting policies and their application, and the clarity and completeness of the company's financial statements, which include related disclosures. The discussion also should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.

Section 204, "Auditor Reports to Audit Committees," of the Sarbanes-Oxley Act of 2002 also requires registered public accounting firms report to the audit committee the following:

1. All critical accounting policies and practices to be used;

2. All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

3. Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

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Discussion Question -

3. Should the auditor's report provide more description about the accounting employed in the financial statements, such as the auditor's judgments about the quality of the financial reporting?

Financial Accounting Framework and the Auditor's Reporting Model

In November 2003, the American Assembly issued a report (the "Assembly Report") titled *The Future of the Accounting Profession*.[2/] The Assembly Report recommended that a new kind of financial reporting model be implemented with a new kind of audit opinion. For instance, the Assembly Report envisioned:

> The balance sheet of the future containing line items similar or identical to those used today by companies and within specific industries, including comparisons to prior years. But this new balance sheet would permit the display of different kinds of numbers – either in a range, or presented as alternatives. This approach could be used to portray cash transactions for which audit assurance is highest, the historical cost allocations of prior cash transactions, market values from actual arms'-length transactions, where available, or other market pricing mechanisms, as well as estimated fair values when no reliable market pricing mechanism exists.

The Assembly Report suggested that such a change in approach would offer investors a broader array of information.

The Assembly Report suggests a "new and more flexible approach to preparing financial statements" to allow companies and their auditors to fairly present this inherent uncertainty. The Assembly Report states:

> In cases where an item has a relevant historical cost (such as depreciable fixed assets), or where the item has a real market value (such as securities for which there is a trading market capable of absorbing a position of the size held) it is reasonably straight forward. But for those line items for which historical cost is irrelevant, and for which no ready market exists, there needs to be a different notation. The premise is simple: give preparers and auditors of financial statements the freedom

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[2/] The 103rd American Assembly, November 13-15, 2003, *The Future of the Accounting Profession* (New York: The American Assembly, Columbia University).

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> and flexibility they need to inform the users of those balance sheets and income statements when the information contained in them is, by definition, uncertain.

In addition, the Assembly Report suggests including additional nonfinancial performance metrics to financial reports to help users compare companies within a specific industry.

With respect to the auditor's report on such a new financial reporting model, the Assembly Report states:

> The current system, with its single, over-arching attestation, cannot adequately address the discomfort that an auditor would feel – justifiably – if he or she were asked to attest to some of the more subjective terms that the [Assembly] participants propose to include in future financial statements… Ideally, auditors would use the current wording to vouch for the most concrete, non-speculative aspects of future financial statements, such as those items for which historical cost is an adequate accounting metric. For information that is more subject to individual judgments by management and auditors, those auditors would give a significantly more limited attestation, perhaps nothing more than a procedural attestation. In these instances, the audit function could be structured in such a way as to verify that a company has reached these judgments with respect to estimated fair value using a clear and seemingly reasonably process. The auditor would not, however, have to attest to the estimate itself. It may be that some of these values are better presented as a range of numbers rather than as a single number.
>
> A variety of other attestation standards may also prove helpful and relevant when it comes to reflecting varying degrees of certainty that are part of the new financial reporting system advocated by Assembly participants. We do not take any position with respect to any specific attestation standard and how such an individual attestation standard might be applied to specific kinds of financial information. Rather, we propose a broad principle: The attestation standard should match the nature of the information to which the auditor is expected to attest. Just as expectations regarding the exactitude of financial statements must change, expectations of what the audit opinion means must change to reflect the

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varying degrees of attestation that will be appropriate for the new information in financial statements.

To fully achieve the goals outlined in the Assembly Report would require the Financial Accounting Standards Board to revise the financial reporting model, and the PCAOB to make corresponding revisions to the auditor's report. However, some of the goals outlined in the Assembly Report could be explored using the current financial reporting model under GAAP. One possibility is for the auditor to provide differing levels of assurance on different accounts or disclosures in the financial statements. For example, different levels of assurance could be provided on accounts such as cash and trade accounts payable as compared to the allowance for doubtful accounts and the valuation of stock option grants due to the level of estimations that the latter two require. Another possibility is for the auditor to provide a different level of assurance on those amounts for which the company has obtained experts to perform the valuation, such as in the area of pension valuations. The challenge is in determining which type of auditor assurance should be applied to different parts of the financial statements and in determining the appropriate financial statement parts.

Discussion Question –

4. Should the auditor's reporting model be revised to provide differing levels of assurance on different parts of the financial statements?

Identification of Individual Auditors in the Audit Report

Rule 2-02 of SEC Regulation S-X states that "The accountant's report (1) shall be dated; (2) shall be signed manually; (3) shall indicate the city and State where issued; and (4) shall identify without detailed enumeration the financial statements covered by the report." Current practice is that audit report signatures show the name of the firm and not the individual signing the report.

Some have indicated that the audit report signature should include not only the name of the firm, but also the name of the audit partner responsible for the audit (and possibly the second or concurring review partner). Proponents of this approach argue that requiring the inclusion of the audit partner (and second partner) would be analogous to Section 302 certifications under the Sarbanes-Oxley Act of 2002 whereby the principal executive officer or officers and the principal financial officer or officers certify to the accuracy of each annual or quarterly report filed with the SEC. Some believe that audit partners (and second partners) should likewise take such personal

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responsibility for the audit reports they sign-off on and that naming the individuals in the auditor’s report might reinforce to those auditors the importance of performing the audit diligently.

Opponents argue that Section 302 reaffirmed management's responsibility under the securities laws and that Section 302 was put in place because management was attempting to disavow responsibility for the financial statements. Opponents further argue that individual partners should not be named in auditor's reports, because the firm takes overall responsibility for the audit report. In addition, limiting the signature to the names of the individual partners could be perceived as a limitation of responsibility. Also, providing individual signatures might be inconsistent with the spirit of the Sarbanes-Oxley Act of 2002 and new standards, which strengthen firm-based quality control over individual audits.

Discussion Question –

5. Should the audit report signature include the name of the partner and second partner signing-off on the report or other members of the engagement team?

Part of Audit Performed by Other Independent Auditors

As indicated above, audit reports filed with the SEC are signed by an auditor (also referred to as the principal auditor). In some instances, an audit report makes reference to an other auditor, but most often audit reports do not contain such references. For instance, even though it is common practice for accounting firms with global practices to use other public accounting firms, typically there is no reference to the use of other auditors in audit reports. Thus, a U.S. firm that is part of an international network of accounting firms may use auditors in China, France, South Africa, Mexico, and Russia to perform portions of an audit.

AU section 543, *Part of Audit Performed by Other Independent Auditors*, provides guidance on the professional judgments the independent auditor makes in deciding (a) whether he may serve as principal auditor and use the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented, and (b) the form and content of the principal auditor's report in these circumstances.

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The auditor considering whether he or she may serve as the principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the audit may have been performed by other auditors. In the latter case, the auditor must decide whether his or her participation is sufficient to serve as the principal auditor.

If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's work or report. On the other hand, if the principal auditor decides not to assume that responsibility, the report should make reference to the audit of the other auditor and should indicate clearly the division of responsibility between the principal auditor and the other auditor in expressing an opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and his or her own report.

In accordance with paragraph .05 of AU section 543, ordinarily a principal auditor will not make reference to an other auditor in the following circumstances:

- Part of the audit is performed by another independent auditor which is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm;

- The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control;

- The principal auditor, whether or not he selected the other auditor, nevertheless takes steps he considers necessary to satisfy himself as to the audit performed by the other auditor and accordingly is satisfied as to the reasonableness of the accounts for the purpose of inclusion in the financial statements on which he is expressing his opinion; or

- The portion of the financial statements audited by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

The United States is one of very few jurisdictions that permits a principal auditor to divide responsibility in his or her audit report with another auditor. In most parts of the world, either accepted practice or law does not permit auditors to divide responsibility.

The SEC Division of Corporation Finance's practice is to require that the principal auditor is expected to have audited or assumed responsibility on at least 50 percent of the assets and revenues of the consolidated entity. If it is impracticable for a principal auditor to assume that extent of responsibility for one or more of the periods presented, the SEC staff will evaluate whether to accept the audit reports as sufficient for reliance in filings with the SEC depending on the facts and circumstances.

The International Auditing and Assurance Standards Board ("IAASB") of the International Federation of Accountants has been considering the issue of using the work of other auditors. In December 2003, the IAASB issued an exposure draft on a proposed revision of International Standard of Auditing ("ISA") 600, *The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements*, and a proposed new International Auditing Practice Statement ("IAPS"), *The Audit of Group Financial Statements*. The IAASB is considering whether to eliminate the existing provision in the ISAs that permits the principal auditor to divide responsibility.

Discussion Question –

6. Should audit reports contain more disclosures about the work performed by other auditors, including auditors from affiliated firms?

IAASB's New Standard for the Form of an Auditor's Report

In December 2004, the IAASB issued an updated ISA that establishes a new form of auditor's report. Appendix B to this paper presents the basic elements of the report, including an illustrative example.

Revised ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements,* provides that the auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework. The report also should state that management's responsibility includes:

- Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;

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- Selecting and applying appropriate accounting policies; and

- Making accounting estimates that are reasonable in the circumstances.

The PCAOB interim standards are not as descriptive with respect to management's responsibility. Rather, the auditor's report includes a statement that the financial statements are the responsibility of the company's management. PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, states that in order for the auditor to satisfactorily complete an audit of internal control over financial reporting, management must accept responsibility for the effectiveness of the company's internal control over financial reporting and evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria, among other things. If management has not fulfilled these responsibilities, which are required by the securities laws, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion.

In addition to internal control certifications, the Sarbanes-Oxley Act of 2002 (Section 302) requires certifications by the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, that:

- The annual or quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading, and

- The financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.

Discussion Question –

7. What responsibilities of management should the auditor's report describe, and should the auditor disclaim his or her opinion if management does not fulfill those responsibilities?

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APPENDIX A

PCAOB Interim Auditing Standards
Basic Elements of the Auditor's Report & Illustrative Example

Excerpted from AU section 508, *Reports on Audited Financial Statements,* and PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*

<u>Basic Elements of the Auditor's Report</u>

1. A title that includes the word independent

2. A statement that the financial statements identified in the report were audited

3. A statement that the financial statements are the responsibility of the Company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit

4. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States)

5. 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

6. A statement that an audit includes –

   a. Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements

   b. Assessing the accounting principles used and significant estimates made by management

   c. Evaluating the overall financial statement presentation

7. A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion

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8. 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 U.S. as the country of origin of those accounting principles

9. The manual or printed signature of the auditor's firm

10. City and state or country

11. The date of the audit report

Illustrative Example

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. 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.

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In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[Signature]
[City and State or Country]
[Date]

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APPENDIX B

IAASB International Standard on Auditing
Basic Elements of the Auditor's Report & Illustrative Example

Excerpted from International Standard on Auditing 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements"

<u>Basic Elements of the Auditor's Report</u>

1. Title
2. Addressee
3. Introductory paragraph
4. Management’s responsibility
5. Auditor’s responsibility
6. Auditor’s opinion
7. Other reporting responsibilities
8. Auditor’s signature
9. Date of the auditor’s report
10. Auditor’s address

<u>Illustrative Example</u>

<u>Independent Auditor's Report</u>

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement,

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statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of *(or "present fairly, in all material respects,")* the financial position of ABC Company as of December 31,

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20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities]

[Auditor's signature]
[Date of the auditor's report]
[Auditor's address]