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I. Summary

The Board is adopting a new auditor reporting standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "final standard" or "AS 3101") and related amendments to its auditing standards that will require the auditor to provide new information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- Communication of critical audit matters—matters 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 especially challenging, subjective, or complex auditor judgment;
- Disclosure of auditor tenure—the year in which the auditor began serving consecutively as the company's auditor; and
- Other improvements to the auditor's report—a number of other improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

The Board believes that adopting these requirements responds to the strong interest of investors for enhanced communication about the audit and is consistent with its mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."¹

The Board is adopting the final standard after more than six years of outreach and public comment, including comments from members of the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG"). The Board has taken into consideration all comments and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate.

Investors are the beneficiaries of the audit and the auditor's report is the primary means by which the auditor communicates with them. Currently, however, the auditor's report conveys little of the information obtained and evaluated by the auditor as part of

¹ Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7211(a).

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, including fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, but the auditor's report does not communicate this information to investors. Stated differently, the auditor's report does little to address the information asymmetry between investors and auditors,² even though investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for their benefit.³ The Board believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management. Outside the United States, other regulators and standard setters have already adopted expanded auditor reporting.

The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed these matters. The Board believes that these matters will likely 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; significant unusual transactions; and other significant changes in the financial statements. The final standard is designed to elicit more information about the audit directly from the auditor. The Board believes that the critical audit matter requirements will respond to requests from investors for more information from the auditor while appropriately addressing concerns raised by other commenters.

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

³ See PCAOB IAG survey, *Improving the Auditor's Report* (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 Board public meeting transcripts and participant statements (Apr. 2-3, 2014), 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").

Investors and investor advocates have suggested a variety of ways in which investors can use the information provided in critical audit matters. In the view of some investors, critical audit matters will add to the total mix of information, providing insights relevant in analyzing and pricing risks in capital valuation and allocation, and contributing to their ability to make investment decisions. Investors also stated that critical audit matters will focus their attention on key financial reporting areas and identify areas that deserve more attention, enhancing the efficiency of investors and others in the consumption of financial information. Some investors believe that critical audit matters will highlight areas that they may wish to emphasize in their engagement with the company and provide important information that they can use in making proxy voting decisions, including ratification of the appointment of auditors.

The final standard also includes a new required statement in the auditor's report disclosing the year in which the auditor began serving consecutively as the company's auditor, as well as a number of other improvements to the auditor's report, such as a statement regarding the requirement for the auditor to be independent. Requiring disclosure of auditor tenure in the auditor's report will make this information readily accessible in a timely way for investors who find it useful. The other improvements to the auditor's report are intended to enhance the user's understanding of the auditor's role and responsibilities related to the audit of the financial statements, make the auditor's report easier to read, and provide a consistent format.

The final standard will generally apply to audits conducted under PCAOB standards. However, communication of critical audit matters is not required for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 (the "Exchange Act") Rule 17a-5; investment companies other than business development companies; employee stock purchase, savings, and similar plans ("benefit plans"); and emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Exchange Act. Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily. The other requirements of the final standard will apply to these audits.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and complexity of the audit.

The Board is adopting a phased approach to the effective dates for the new requirements to provide accounting firms, companies, and audit committees more time to prepare for implementation of the critical audit matter requirements, which are expected to require more effort to implement than the additional improvements to the auditor's report. Subject to approval by the Securities and Exchange Commission ("SEC"), the final standard and amendments will take effect as follows:

- All provisions other than those related to critical audit matters will take effect for audits of fiscal years ending on or after December 15, 2017; and
- Provisions related to critical audit matters will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

Auditors may elect to comply before the effective date, at any point after SEC approval of the final standard.

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").⁴ 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 contributes to greater complexity in financial reporting. ACAP said this complexity supported improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.

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 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

⁴ 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, *The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (1978).

discussed at the March 2011 IAG meeting.⁵ Some investors who participated in that meeting suggested that expanded auditor reporting would have been helpful before and during the 2008 financial crisis.⁶ Later in March 2011, the Board held an open meeting to discuss findings from its outreach.⁷

In June 2011, the Board issued a concept release to solicit comment on a number of potential changes to the auditor's report.⁸ The Board received 155 comment letters on the concept release. The Board also held a public roundtable in September 2011 to obtain additional insight on the alternatives presented in the concept release.⁹ Changes to the auditor's report were also discussed at the November 2011 and 2012 meetings of the Board's SAG.¹⁰

After considering the results of its outreach and comments on its concept release, in August 2013, the Board proposed an auditing standard that included new requirements for auditors to communicate critical audit matters, as well as additional improvements to the auditor's report.¹¹ The Board received 248 comment letters on the

⁵ See IAG meeting details and webcast (Mar. 2011), available on the Board's website.

⁶ See IAG working group presentation, *Lessons Learned from the Financial Crisis* (Mar. 16, 2011), available on the Board's website.

⁷ See PCAOB open Board meeting details and webcast (Mar. 22, 2011), available on the Board's website.

⁸ 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").

⁹ See PCAOB roundtable transcript (Sept. 15, 2011), available on the Board's website in Docket 034.

¹⁰ See SAG meeting transcripts (Nov. 2011 and 2012), available on the Board's website in Docket 034.

¹¹ 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) ("proposal").

proposal. Most commenters 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.¹² Investors, analysts, and larger accounting firms generally supported communication of critical audit matters with some modifications, while many smaller accounting firms were less supportive, and preparers and audit committee members generally opposed communication of critical audit matters. Commenters generally supported the additional improvements to the auditor's report other than the disclosure of auditor tenure in the auditor's report, which investors supported and some other commenters opposed or suggested should be provided in a different document, such as the proxy statement.

In April 2014, the Board held a public meeting to obtain further input on the proposal from a diverse group of investors and other financial statement users, preparers, audit committee members, auditors, and others.¹³ The proposal was further discussed at the November 2013 and June 2014 SAG meetings, and the October 2013 and 2014 IAG meetings.¹⁴

In May 2016, the Board issued a reproposal of the auditor reporting standard that modified the proposal in several respects.¹⁵ In particular, the reproposal modified the source, definition, and communication requirements for critical audit matters. The Board received 88 comment letters on the reproposal. The reproposal was discussed at the May 2016 SAG meeting and October 2016 IAG meeting.¹⁶

¹² See comment letters on the proposal, available on the Board's website in Docket 034.

¹³ See public meeting transcripts and participant statements (Apr. 2-3, 2014), available on the Board's website in Docket 034.

¹⁴ See SAG (Nov. 2013 and June 2014) and IAG meeting transcripts (Oct. 2013 and 2014), available on the Board's website in Docket 034.

¹⁵ See *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) ("reproposal").

¹⁶ See SAG (May 18, 2016) and IAG (Oct. 27, 2016) meeting transcripts, available on the Board's website in Docket 034.

Several commenters on the reproposal suggested that the Board engage in further outreach, field testing, or further study before finalizing the standard. One commenter suggested deferral until the SEC completes any rulemaking on its "disclosure effectiveness" initiative. However, other commenters commended the Board on the extensive outreach already performed. The Board believes that its extensive outreach provides an adequate basis to adopt the final standard.

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 have undergone 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 align the final standard with the requirements of other regulators and standard setters. The Board recognizes that the regulatory environments in other jurisdictions are different from the environment in the United States; the Board must address unique U.S. requirements and characteristics in its standard-setting projects. Even so, the Board has considered carefully the efforts undertaken in other jurisdictions, and, as described in more detail below, the final requirements are analogous in many respects to auditor reporting requirements 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.¹⁷ 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.¹⁸ Key audit matters are selected

¹⁷ The IAASB changes to the auditor's report are effective for audits of financial statements for periods ending on or after December 15, 2016.

¹⁸ See paragraph 8 of International Standard on Auditing ("ISA") 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

from matters communicated with those charged with governance and that required significant auditor attention in performing the audit.¹⁹ The IAASB requires that the description of each key audit matter in the auditor's report include: (1) why the matter 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.²⁰

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,²¹ an enhanced description of the responsibilities of the auditor,²² and requiring the auditor's opinion to be the first paragraph of the auditor's report.²³

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.²⁴ 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.

¹⁹ See paragraph 9 of ISA 701.

²⁰ See paragraph 13 of ISA 701.

²¹ See paragraph 28(c) of ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*.

²² See paragraph 37 of ISA 700.

²³ See paragraph 23 of ISA 700.

²⁴ See Article 10, *Audit Report*, of Regulation (EU) No 537/2014 of the European Parliament and of the Council ("Regulation (EU) No 537/2014") (Apr. 16, 2014). EU member states had 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 in the "Audit reform in the EU" section of the European Union's webpage.

FRC. In June 2013, the FRC revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code.²⁵ The auditors of those entities were 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 were required to provide an explanation of how the scope of the audit addressed the risks.²⁶

In April 2016, the FRC adopted a final rule, which applies to all listed entities, updating its 2013 auditor reporting requirements to incorporate the EU²⁷ and the IAASB requirements.²⁸ 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.²⁹

²⁵ 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 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).

²⁶ 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.

²⁷ In response to questions about the implications of the June 2016 UK referendum decision to leave the EU, the FRC has stated: "Our regulatory framework is unchanged and we will continue to apply it." See *FRC statement following the referendum vote to leave the EU* (June 24, 2016).

²⁸ See the FRC's Final Draft, ISA (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.

²⁹ See FRC, *Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance*

2. *Comparison of the Board's Final Standard 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 final standard. All of these initiatives 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 vary across jurisdictions, there are commonalities in the underlying criteria 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.

Sections IV and V include descriptions of the IAASB, EU, and FRC requirements that are analogous to the key provisions of the final standard. In April 2016, the FRC adopted a final rule that updated its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, but auditor reporting under that final rule has not occurred yet. Because the FRC 2013 requirements govern the expanded auditor reporting that has occurred in the United Kingdom to date and are 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 final standard. It requires the auditor to communicate "key audit matters" selected from matters communicated with those charged with governance. In May 2016, the IAASB published a comparison between its standard and the Board's reproposal, which noted many similarities between the requirements of key audit matters and critical audit matters, including the framework for determination of the matters to be communicated, the considerations underlying the determination requirement, and communication requirements.³⁰ Many commenters on the reproposal were supportive of the Board's closer alignment with the IAASB.

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 final standard. The FRC has stated 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).³¹ Under the Board's final

on Audit Committees (Sept. 2015).

³⁰ See IAASB, *The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal* (May 2016).

³¹ See FRC, *Extended Auditor's Reports, A Further Review of Experience*

standard, the auditor's assessment of the risks of material misstatement is one of the factors for the auditor to consider in determining critical audit matters.

The IAASB and the FRC 2013 requirements are accompanied by application and other explanatory materials that provide further guidance on the standards. Because these materials are not part of the requirements, they are not addressed in the descriptions of the requirements of other regulators and standard setters presented in Sections IV and V.

III. Overview of the Final Standard

The Board is adopting a new auditor reporting standard, which is attached as Appendix 1. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

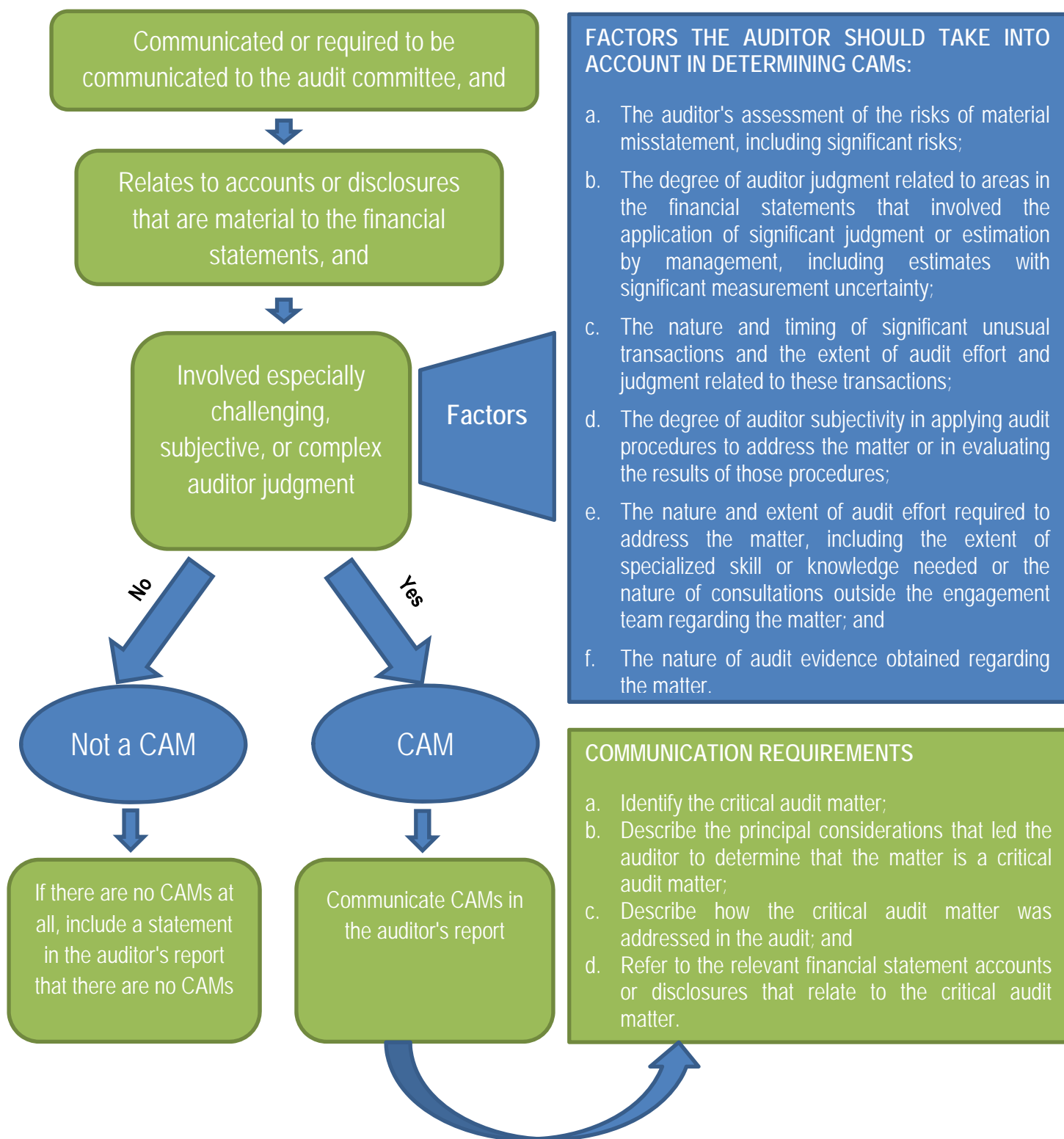
- *Critical audit matters* (see chart on page 14)—requires the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit of the financial statements or state that the auditor determined that there are no critical audit matters:
 - A critical audit matter is 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 takes into account, alone or in combination, certain factors, including, but not limited to:
 - The auditor's assessment of the risks of material misstatement, including significant risks;
 - 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;
- The degree of auditor subjectivity in 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; and
- The nature of audit evidence obtained regarding the matter.
- The communication of each critical audit matter includes:
 - 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 the critical audit matter was addressed in the audit; and
 - Referring to the relevant financial statement accounts or disclosures.
- The documentation of critical audit matters requires that for each matter arising from the audit of the financial statements that (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, the auditor documents whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.
- *Additional Improvements to the Auditor's Report*—the final standard 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, and make the auditor's report easier to read:
 - *Auditor tenure*—a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;

- *Independence*—a statement that the auditor is required to be independent;
- *Addressee*—the auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted);
- *Enhancements to basic elements*—certain standardized language in the auditor's report has been changed, 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
- *Standardized form of the auditor's report*—the opinion will appear in the first section of the auditor's report and section titles have been added to guide the reader.

The Board intends to monitor the results of implementation, including consideration of any unintended consequences.

Determining and Communicating Critical Audit Matters ("CAMs")



IV. Discussion of the Final Standard

A. Critical Audit Matters

Under the final standard, the auditor will be required to communicate critical audit matters in the auditor's report in order to provide more information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users.

Investor, investor advocate, and analyst commenters generally supported the repropoed 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, focusing attention on issues that would be pertinent to understanding the financial statements, and enhancing investor confidence in the financial statements.

The larger and some smaller accounting firms generally supported including critical audit matters in the auditor's report with some modification of the repropoed requirements. Other commenters, including other smaller accounting firms, companies, and audit committee members, did not support the requirements. Some of 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.

Other commenters suggested that the Board align the definition of critical audit matters with the IAASB's definition of key audit matters to enhance overall consistency.

Consistent with the Board's statutory mandate under Section 101(a) of Sarbanes-Oxley and in response to the ACAP recommendation and continued investor support for expanded auditor reporting, the final standard includes the requirement to communicate critical audit matters substantially as repropoed. The Board has taken into consideration all comments, including concerns raised by some commenters, which are described in more detail below, and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate. The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed those matters.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and

complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

1. *Determination of Critical Audit Matters*

a. Definition of Critical Audit Matter

The repropoed standard defined a critical audit matter as any matter arising from the audit 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*. For the reasons explained below, the Board is adopting the definition as repropoed.

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

Most commenters agreed that matters communicated or required to be communicated to the audit committee would be the appropriate source for critical audit matters. These commenters stated that matters communicated to the audit committee are the most meaningful to users of the financial statements and using them as the source of critical audit matters would assist the auditor in determining critical audit matters in the most efficient and effective manner.

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;
- 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.

Several commenters suggested revising the source of critical audit matters. Some suggested narrowing the source of critical audit matters only to matters required to be communicated to the audit committee, on the basis that this would avoid chilling communications regarding non-required matters and reduce the burden of

documentation. Other commenters suggested that the Board consider, as an alternative, selecting critical audit matters only from critical accounting policies and estimates disclosed by management, which some said would eliminate the potential for the auditor to become the original source of information, as well as the potential for conflicting disclosures between the auditor and management. Some commenters also recommended not specifying the source for critical audit matters and leaving it up to auditor judgment. Other commenters suggested broadening the source of critical audit matters to include matters documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated with management and other members of the board of directors, as the Board had originally proposed in 2013.

The final standard retains the source of critical audit matters as repropoed. Critical audit matters will 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). The source will include auditor communication requirements under AS 1301, *Communications with Audit Committees*, other PCAOB rules and standards,³² and applicable law,³³ as well as communications made to the audit committee that were not required. This approach scopes in the broadest population of audit committee communications and will not require the auditor to determine whether matters communicated to the audit committee were required to be communicated. However, it seems likely that matters that meet the definition of a critical audit matter will usually relate to areas that are required to be communicated to the audit committee, either under a specific communication requirement or the broad provisions of paragraph .24 of AS 1301, which requires communication of matters arising from the audit that are significant to audit committee oversight of the 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, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements.

³² See Appendix B of AS 1301, which identifies other PCAOB rules and standards that require audit committee communication, such as AS 2410, *Related Parties*, and AS 2502, *Auditing Fair Value Measurements and Disclosures*.

³³ 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 Exchange Act Rule 10A-3, 17 CFR 240.10A-3.

The final standard does not limit the source of critical audit matters to critical accounting policies and estimates because the Board does not believe this would be an appropriate starting point in light of investor interest in a broader range of topics related to the audit. Additionally, the final standard does not broaden the source, as proposed in 2013, to also include matters documented in the engagement completion document and reviewed by the engagement quality reviewer because 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.

Some commenters suggested that using audit committee communications as the source for critical audit matters could impair the relationship between auditor, management, and the audit committee (e.g., chill communications, give rise to conflict, or cause auditors to communicate more than they otherwise would). However, other commenters argued that critical audit matters would enhance, not impair, communications between auditors, investors, and those charged with governance (including audit committees). For matters required to be communicated to the audit committee, the Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing. It would seem that any chilling effect would more likely relate to matters that are not explicitly required to be communicated to the audit committee, although given the broad requirements of AS 1301 (particularly paragraph .24), the Board believes that there may be few, if any, relevant communications affected by that possibility.

Some commenters suggested excluding certain required audit committee communications from the source of critical audit matters, generally because these communications relate to sensitive areas and may result in the auditor communicating information not disclosed by management. Suggestions included: corrected and uncorrected misstatements, qualitative aspects of significant accounting policies and practices, alternative treatments within generally accepted accounting principles ("GAAP") for policies and practices related to material accounts, violations or possible violations of law or regulation, independence considerations, disagreements with management, other material written communications between the auditor and management, overall planned audit strategy, delays encountered in the audit, and competency issues of management. Other commenters argued that no audit committee communications should be specifically excluded from consideration as a source of potential critical audit matters.

The final standard does not exclude any required audit committee communications from the source of critical audit matters. To the extent that any such communication met the critical audit matter definition (including that it (1) relates to accounts or disclosures that are material to the financial statements and (2) involved

especially challenging, subjective, or complex auditor judgment), the Board believes it will be an appropriate subject for an auditor to communicate as a critical audit matter.

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

The materiality component of the repropoed definition of critical audit matters—that the matter "relates to accounts or disclosures that are material"³⁴ to the financial statements"—was intended to respond to investor requests for informative and relevant auditor's reports while, at the same time, addressing other commenters' concerns regarding auditor communication of immaterial information that management is not required to disclose under the applicable financial reporting framework and SEC reporting requirements.

Some investor commenters suggested removing the materiality component of the repropoed definition of critical audit matters, arguing that it made the definition too narrow and would unnecessarily exclude relevant information. Some of these commenters observed that many cases of material accounting problems or fraud started as 'immaterial' to the financial statements and built over time, and that such matters may not meet the repropoed definition of a critical audit matter because of the materiality component.

Other commenters, primarily companies and accounting firms, argued that the repropoed definition was too broad and suggested modifying the materiality component such that a critical audit matter would itself have to be material to the financial statements as a whole, rather than relating to accounts or disclosures that are material to the financial statements. These commenters expressed concern that the phrase "relates to accounts or disclosures that are material to the financial statements" could apply to too many matters, resulting in the auditor disclosing immaterial matters that would not otherwise be disclosed by management, or give the impression of a piecemeal opinion.

³⁴ 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, 231-32 (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.

After consideration of comments, the Board has determined to adopt the materiality component in the final definition of critical audit matter as repropoed. In the Board's view, the purpose of the standard—making the auditor's report more useful and informative to investors—is better served by auditor communication of matters related to accounts or disclosures that are material to the financial statements. As one commenter noted, limiting the source of critical audit matters and adding a materiality component that directly relates to accounts and disclosures "would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of [critical audit matters] within the auditor's report that could deemphasize their importance."³⁵

At the same time, in the Board's view, limiting critical audit matters to those that are, in and of themselves, material to the financial statements as a whole would not serve the intended purpose of the standard. If the auditor were required to determine that a critical audit matter itself is material, rather than related to an account or disclosure that is material, it is likely that fewer matters would meet the definition of a critical audit matter and, thus, investors would likely receive less, and less audit-specific, information than under the standard as adopted.

Accordingly, as in the reproposal, the final standard provides that each critical audit matter relates to accounts or disclosures that are material to the financial statements. Consistent with the reproposal, "relates to" clarifies that the critical audit matter could be a component of a material 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 if goodwill was material to the financial statements, even if there was no impairment; it would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company's impairment policy and goodwill. 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 if it relates to many accounts or disclosures. For example, the auditor's evaluation of the company's ability to continue as a going concern could also represent a critical audit matter depending on the circumstances of a particular audit.

On the other hand, a matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter. For example, a potential loss contingency that was communicated to the audit committee, but that was

³⁵ See letter from Dixon Hughes Goodman, LLP (Aug. 15, 2016) at 2, available on the Board's website in Docket 034 (also noting that there is a continuing risk that the auditor could disclose information about the company that was not previously disclosed by the company).

determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a critical audit matter; it does not relate to an account or disclosure in the financial statements, even if it involved especially challenging auditor judgment. The same rationale would apply to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements; the matter would not relate to an account or disclosure that is material to the financial statements.

For the same reason, the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, cannot be a critical audit matter; such determination, in and of itself, does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. A significant deficiency could, however, be among the principal considerations that led the auditor to determine that a matter is a critical audit matter.³⁶

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

Many commenters supported including "matters that involved especially challenging, subjective, or complex auditor judgment" in the reposed definition of a critical audit matter. Other commenters argued that the phrase "especially challenging, subjective, or complex auditor judgment" is broad and subjective and would lead to inconsistent application of the reposed definition. For example, some commenters said that critical audit matters would vary based on the experience and competence of the auditor, even if the underlying facts and circumstances were the same. One commenter urged disclosure of the auditor's perspective on material related party transactions. Another commenter suggested that the standard include a note stating that it is expected that in most audits, financial statement matters involving the application of significant judgment or estimation by management would involve especially challenging, subjective, or complex auditor judgment.

Several commenters suggested using the IAASB's definition of key audit matters, which includes those matters that were of most significance in the audit of the financial statements and that required significant auditor attention. One commenter argued that this would avoid reliance on the auditor's determination of whether a matter involved especially challenging, subjective, or complex auditor judgment, which the commenter said would give auditors too much discretion.

³⁶ See section IV.A.2.c.i for additional considerations related to auditor disclosure of original information.

After consideration of comments, the Board is adopting this component of the definition of critical audit matter as repropoed, namely "matters that involved especially challenging, subjective, or complex auditor judgment." This grounds the definition in the auditor's expertise and judgment, which is directly responsive to investor requests for information from the auditor's point of view. Thus, the Board believes that this definition will focus critical audit matters in areas where investors will particularly benefit from expanded reporting by the auditor.

The determination of critical audit matters is principles-based and the final standard does not specify any items that 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.³⁷ 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, improper revenue recognition is a presumed fraud risk and all fraud risks are significant risks;³⁸ however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it will not be a critical audit matter. Similarly, the final standard does not provide, as some commenters suggested, that material related party transactions or matters involving the application of significant judgment or estimation by management always constitute critical audit matters. The auditor must determine, in the context of the specific audit, that a matter involved especially challenging, subjective, or complex auditor judgment. In addition, focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. To the extent that critical audit matters reflect differences in auditors' experience and competence, this in itself should also be informative.

b. Factors

The reproposal included the following nonexclusive list of factors for the auditor to take into account, together with audit-specific factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

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

³⁷ A significant risk is a "risk of material misstatement that requires special audit consideration." Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

³⁸ See AS 2110.71.

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

Commenters in general agreed that including such factors would assist the auditor in determining critical audit matters.

Some commenters suggested changes to better align the factors with areas of complex management judgment, to reduce the risk that the auditor would be the source of original information, to clarify the linkage of procedures performed by the auditor and sufficient appropriate audit evidence obtained in performing those procedures, and to focus the auditor on the audit procedures executed to obtain sufficient and appropriate audit evidence rather than audit strategy decisions. Some commenters suggested harmonizing the factors with the IAASB's factors for determining key audit matters.

After considering the comments received, the Board has modified the factors by reordering them and revising the factor relating to the degree of auditor subjectivity (factor b above) to refer to the application (rather than determination) of audit procedures, which focuses it more clearly on the performance of the audit rather than audit strategy.

Some commenters suggested that the factor pertaining to the nature and extent of the audit effort (factor c) be revised to relate to the nature and extent of audit effort required to obtain sufficient appropriate audit evidence to address a matter and the factor pertaining to the nature of audit evidence (factor f) be deleted to clarify that obtaining audit evidence is a component of audit effort. The final standard does not change factor c as suggested because it would inappropriately narrow the factor exclusively to considerations related to obtaining audit evidence rather than the nature

of the overall audit effort. Additionally, the Board determined to retain factor f as a stand-alone factor because, as stated in the reproposal, in the limited implementation trial conducted by several accounting firms, this factor appeared to be one of the most useful in determining critical audit matters.³⁹

A commenter recommended including a factor based on the extent of interaction with the audit committee. The final standard does not include this factor because the extent of interaction might not be a meaningful indicator of the complexity or subjectivity of the matter and it could create incentives to limit communication between the auditor and the audit committee.

One commenter did not agree with elimination of two proposed factors that related to the severity of control deficiencies and corrected and uncorrected misstatements. These factors were eliminated from the reproposal in response to comments that the factors would lead the auditor to determine matters as critical audit matters in areas where the company has no existing reporting obligation, or where the company has determined that the matters are not material and therefore do not require disclosure under the financial reporting framework. For these reasons, the final standard does not include these factors.

Under the final 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 should take into account the following nonexclusive list of factors, as well as other audit-specific factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

- a. The auditor's assessment of the risks of material misstatement, including significant risks;
- b. 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;
- c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

³⁹ See letter from the Center for Audit Quality (June 19, 2014) at 5, available on the Board's website in Docket 034.

- d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
- e. 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; and
- f. 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 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 one or more of these factors, other factors specific to the audit, or a combination.

c. **Audit Period Covered by Critical Audit Matters**

The reproposal 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 reproposed standard provided that 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) 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.

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 supported communication of critical audit matters for all periods presented along with an explanation if prior year critical audit matters are not repeated in the current year. Yet another commenter stated that the auditor should be encouraged to use judgment as to whether to include critical audit matters for prior periods and not limit the consideration only to the circumstances described in the reproposal.

The final standard 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 auditor's reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented, will 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 will be able to look at prior years' filings to analyze critical audit matters over time. However, the auditor could choose to include critical audit matters for prior periods. The final standard clarifies that the two situations relating to a prior period are examples rather than the only situations in which a critical audit matter for a prior period may be communicated.

As noted in the reproposal, if the auditor's report is dual-dated, the auditor will determine whether the new information for which the auditor's report is dual-dated gives rise to any additional critical audit matters.

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 because it is only required for the current year. However, the predecessor auditor could choose to include prior year critical audit matters in the reissued auditor's report.

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 governance⁴⁰ 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.⁴¹

⁴⁰ 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.

⁴¹ See paragraph 9 of ISA 701.

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters.⁴² The IAASB requires the communication of key audit matters for the current period only.⁴³

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.⁴⁴ 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 resources in the audit; and (3) directing the efforts of the engagement team.⁴⁵ The FRC does not specify the period for which these need to be described.

2. *Communication of Critical Audit Matters*

Under the reproposal, the auditor would have been required to include introductory language in the auditor's report preceding the communication of critical audit matters and to communicate critical audit matters by identifying each matter, describing the auditor's principal considerations for determining that the matter was a critical audit matter, describing how the critical audit matter was addressed in the audit, and referring to the relevant financial statement accounts and disclosures.

Comments varied on the repropose requirements for communication of critical audit matters and the level of detail the auditor should provide, including whether the auditor should be permitted to provide information about the company that has not been previously disclosed by the company (which commenters referred to as "original information"). Commenters generally agreed with identifying each critical audit matter and referring to the relevant financial statement accounts and disclosures. One commenter suggested removing the requirements to describe the considerations for determining that a matter was a critical audit matter and how the critical audit matter was addressed in the audit. 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

⁴² See paragraph 10 of ISA 701.

⁴³ See paragraphs 8 and 10 of ISA 701.

⁴⁴ See requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

⁴⁵ See paragraph 19A of UK ISA 700 (2013).

requirements. After consideration of comments, the Board has made some enhancements to the communication requirements, as described below.

a. Introductory Language

The reproposed standard provided introductory language to be included in the "Critical Audit Matters" section of the auditor's report indicating that critical audit matters did not alter the opinion on the financial statements and that the auditor was not providing a separate opinion on the critical audit matters. Some commenters supported the introductory language on the basis that it could minimize users' potential misunderstanding of the critical audit matters.

Some commenters suggested additions to the introductory language to emphasize that critical audit matters are subjective and may not represent the most important aspects of the financial statements, to clarify that the description of procedures should not be taken as indicative of results of any individual procedure, or to limit reliance on critical audit matters by adding language similar to that used in a report on an audit of internal control over financial reporting ("ICFR").⁴⁶ The introductory language in the final standard does not include the suggested additions because such language could be interpreted as disclaiming or inappropriately minimizing the communication of critical audit matters.

Other commenters suggested minor revisions in the introductory language to refer to the "communication of critical audit matters" rather than the critical audit matters themselves. In response to this comment, the required introductory language in the final standard has been revised as follows (additions are underlined and deletions are struck through):

The critical audit matters communicated below are matters arising from the current period audit of the financial statements 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. The

⁴⁶ The auditor's report on the audit of internal control over financial reporting requires 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." See paragraph .85j of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

communication of ~~C~~critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we ~~do~~ are not, by communicating the critical audit matters below, ~~provide~~ providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

b. Communication Requirements

The reproposal required that, for each critical audit matter, 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 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.

As discussed in more detail below, these requirements have been adopted substantially as repropose⁴⁷.

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

Many commenters who addressed this topic supported the identification of the critical audit matter and limiting the description to "the principal considerations" that led the auditor to determine that the matter is a critical audit matter, and those aspects of the communication requirements are adopted as repropose⁴⁷. 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

⁴⁷ The repropose⁴⁷ release included two illustrative examples of the communication of critical audit matters. See PCAOB Release No. 2016-003, Section IV.A.2.b. Given the principles-based nature of the requirements for critical audit matters and the objective of providing tailored, audit-specific information, the examples were intended to function as illustrations of how critical audit matters could be communicated, and not as templates for how critical audit matters should be communicated. Comments received on these examples were taken into account in the Board's consideration of the final standard. Illustrative examples do not appear in the adopting release because the Board believes auditors should provide tailored, audit-specific information when communicating critical audit matters in the auditor's report.

challenging, subjective, or complex auditor judgment. It is expected that the communication will 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

The repropose standard included a new requirement for the auditor to describe how the critical audit matter was addressed in the audit. While the standard did not specify how this should be done, the repropose release provided four examples of potential approaches to such descriptions: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of the 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.⁴⁸

Many commenters were supportive of a requirement to describe how each critical audit matter was addressed in the audit. Some commenters asserted that a description of how a critical audit matter was addressed would benefit investors by providing insights on how and on what basis the auditor developed the opinion or the rigor that underlies the audit procedures performed. For example, one investor commenter stated that including audit procedures in the description of a critical audit matter would make the auditor's report more informative and useful. Several investors suggested that the auditor should be required or encouraged to provide informative, company-specific findings when describing how the critical audit matter was addressed in the audit, such as whether management's significant accounting estimates and judgments were balanced, mildly optimistic, or mildly pessimistic.

One commenter suggested that the description of how the critical audit matter was addressed in the audit should be optional. Several commenters objected to the auditor including audit procedures in the description of critical audit matters because it would not provide any incremental value or actionable information to investors, investors may not have the expertise or context to understand audit procedures, or the description of audit procedures would become boilerplate. One commenter suggested adding a note to clarify that the purpose of describing audit procedures is to provide information about the audit but not specific details that would compromise the effectiveness of audit procedures. Other commenters suggested that only the principal audit procedures should be provided.

⁴⁸ 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.

The final standard includes the requirement for the auditor to describe how the critical audit matter was addressed in the audit because it is consistent with the Board's objective of providing more information about the audit and, if developed with an appropriate focus on the intended audience, should be of interest to users. Similar to the reproposal, the final standard does not prescribe a specific way to meet this requirement. Several commenters suggested that the four examples provided in the reproposing release be included in the standard because they provide helpful guidance on how the requirement could be met. The final standard includes a note incorporating these examples, which should clarify the Board's expectations while providing flexibility in describing how a critical audit matter was addressed in the audit.

While the description of how the critical audit matter was addressed in the audit will 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 will be useful to investors. A brief overview of the audit procedures performed is one of the alternatives for describing how the critical audit matter was addressed. If the auditor chooses to describe audit procedures, the descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, as the four examples should make clear, the objective is to provide a useful summary, not to detail every aspect of how the matter was addressed in the audit. 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.

In its comment letter, a working group of the IAG stressed the importance to investors of auditor findings, which they described as "the one item that [they] believe would provide the greatest value to investors."⁴⁹ Acknowledging the difficulty of mandating reporting of findings, the working group recommended that the Board encourage auditors to include them voluntarily. Under the final standard, communication of the auditor's findings is not required; however, in describing the audit response, the auditor may choose to include findings as an indication of the outcome of audit procedures or key observations about a matter. The Board shares the working group's view that the inclusion of informative, company-specific audit findings related to critical audit matters may, in appropriate circumstances, be valuable to investors and encourages auditors to consider including such findings in their auditor's reports. However, in describing findings, the language used should not imply that the auditor is

⁴⁹ Letter from the IAG's auditor's report working group (Aug. 15, 2016) at 1, available on the Board's website in Docket 034. The working group made a presentation regarding its comment letter at the IAG meeting in October 2016, available on the Board's website.

providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

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

The repropoed standard would have required the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. There were few comments on this requirement. One commenter suggested that, to avoid duplication, reference should be made only to the disclosures and not the financial statement accounts. In response to this suggestion, the final standard clarifies that the auditor could refer to either the relevant account or disclosure, rather than both, to avoid potential duplication.

The reproposal also solicited comment on whether, in addition to referring to the relevant financial statement accounts and disclosures, the auditor should refer to relevant disclosures outside the financial statements. Commenters that addressed this question generally opposed the auditor referencing disclosures outside the financial statements when describing a critical audit matter because it may incorrectly suggest that such information is audited or cause readers to misinterpret the auditor's role in relation to such information. The final standard only requires the auditor to refer to the relevant financial statement accounts or disclosures.

c. Additional Considerations Related to the Communication Requirements

i. Auditor Disclosure of "Original Information" about the Company

The repropoed standard included a note to indicate that, when describing critical audit matters in the auditor's report, the auditor is not expected to provide original information unless it 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.

Investor commenters, including the auditor's report working group of the IAG, argued that there should not be any limitation on the auditor providing original information and that the reproposal went too far in constraining the auditor from providing original information in response to concerns expressed by other commenters (which were primarily companies and accounting firms).

Other commenters expressed the view that auditors should not provide original information about the company or should be limited to providing information about the audit and not the company. These commenters stated that the auditor providing original information about the company would be inconsistent with the traditional U.S. regulatory framework, whereby management provides information about the company and the

auditor attests to compliance with the applicable financial reporting framework. However, one investor commenter noted that auditor reporting should not be limited by "original information," a term that is undefined in auditing literature.

No PCAOB standard, SEC rule, or other financial reporting requirement prohibits auditor reporting of information that management has not previously disclosed. Rather, there are areas under current law and auditing standards that require auditor reporting that goes beyond attesting to the compliance of management disclosures (e.g., substantial doubt about a company's ability to continue as a going concern⁵⁰ or illegal acts⁵¹). As discussed in more detail below, auditors may have professional or state law obligations to maintain client confidentiality, but these obligations should not apply to, or should be preempted by, reporting obligations arising under federal law and regulations, including under PCAOB standards.⁵² Accordingly, the requirement to communicate critical audit matters is not, as some commenters have suggested, inconsistent with the existing U.S. financial reporting framework and auditors' other obligations.

Commenters also said that the role of the audit committee or management would be undermined by requiring the auditor to disclose information about the company's financial statements, since in their view it is solely management's responsibility to determine what disclosure is appropriate. Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management, and that management would likely modify its disclosure in response to the communication of critical audit matters in the auditor's report so the auditor would not be a source of original information. While some commenters said that this would improve management disclosures, others said it would be an inappropriate expansion of the auditor's role or would add significant costs. Other

⁵⁰ See AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*. The auditor is required to include a going concern explanatory paragraph if the auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time (see AS 2415.12). If management's disclosure with respect to the company's ability to continue as a going concern is inadequate, the auditor's reporting responsibility regarding going concern remains and the report includes either a qualified or an adverse opinion (see AS 2415.14).

⁵¹ Auditors may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the Exchange Act), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

⁵² For a more detailed discussion of liability considerations related to critical audit matters, see Section IV.A.4.

commenters stated that companies could be harmed by the disclosure of confidential or competitively sensitive information. Another commenter expressed concern that investors could be confused or misled if auditor reporting lacked context or appeared to conflict with management disclosures. One commenter suggested that the auditor should disclose original information only if a disclosure matter continues to be unresolved after discussion with management and the audit committee.

The Board acknowledges these concerns and, in developing the auditor's communication requirements, has sought to strike an appropriate balance between investor demands for expanded auditor reporting and the costs and potential unintended consequences associated with providing it. While auditor reporting of original information is not prohibited, it is limited to areas uniquely within the perspective of the auditor: describing the principal considerations that led the auditor to determine that the matter is a critical audit matter and how the matter was addressed in the audit. The objective of critical audit matters—helping investors to focus on identified areas of the audit and understand how the auditor addressed them—may not be accomplished if the auditor is prohibited from providing such information. Moreover, prohibiting the auditor from providing such information could make critical audit matter communications incomplete in a way that could be confusing to or misunderstood by investors.

It seems likely, as one commenter observed, that auditors will generally not have incentives to provide information about the company that the company has not already made public. Another commenter noted that, in current practice, disclosure is already guided by an iterative process between management and the auditor, and expected that a similar process would occur for critical audit matters, reducing the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.⁵³ To the extent that an auditor's decision to communicate a critical audit matter incents the company to expand or supplement its own disclosure, the Board believes this may improve the quality of public disclosures, which would be an indirect benefit of the standard. However, if the company does not provide additional disclosure, and the information is necessary to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter or how it was addressed in the audit, the Board believes it is in the public interest for the auditor to include that information in the auditor's report. The final standard therefore retains the note from the reproposal explaining that 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

⁵³ It should be noted, however, that critical audit matters are not a substitute for disclosures required of the company under the applicable financial reporting framework.

considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Of course, any matter that will be communicated as a critical audit matter will already have been discussed with the audit committee, and the auditor will be required to provide a draft of the auditor's report to the audit committee and discuss the draft with them.⁵⁴ In addition, as the auditor determines how best to comply with the communication requirements, the auditor could discuss with management and the audit committee the treatment of any sensitive information.

Some commenters also stated that, in areas where there are specific reporting obligations under the applicable financial reporting framework or SEC reporting requirements but the matter falls below the disclosure threshold (for example, a significant deficiency), auditor communication could, in effect, impose a lower disclosure threshold. With regard to such areas, it is likely that the nature of a critical audit matter and its description would be broader than, for instance, focusing on a significant deficiency. In addition, while the auditor is required to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, (which may include, if relevant, information about the company's processes and controls) and how the overall matter was addressed, it is not necessary for the auditor's description to use the terminology of the other auditing standard, such as "significant deficiency" within the broader context of a critical audit matter. For example, if a significant deficiency was among the principal considerations in determining that revenue recognition was a critical audit matter, the auditor would describe the relevant control-related issues over revenue recognition in the broader context of the critical audit matter without using the term "significant deficiency."⁵⁵

Some commenters suggested that any expanded disclosure requirements should come from the SEC and the Financial Accounting Standards Board ("FASB"), in the form of additional management disclosures, rather than from the Board expanding requirements for auditor reporting. However, investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for the investor's benefit. As one commenter noted, the auditor is best suited to provide insights on how and on what basis the auditor developed its opinion. The final standard is designed to elicit information about the audit directly from the auditor's perspective.

⁵⁴ See AS 1301.21, as amended.

⁵⁵ It should be noted that the determination that a matter was a significant deficiency in internal control over financial reporting, on its own, could not be a critical audit matter. See Section IV.A.1.a.ii.

If auditors can adequately convey to investors the principal considerations and how the auditor addressed the matter without including previously undisclosed information, it is expected that they will. However, the standard provides that even when management has not disclosed information, the auditor is not constrained from providing such information if it 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.

The Board intends to monitor implementation of the critical audit matter requirements to determine if additional guidance is needed in this area.

ii. Potential Compliance Issues Related to Critical Audit Matters

Some commenters suggested that the reporting of critical audit matters could create compliance challenges for companies.

Two commenters expressed concern that companies' SEC filings may have to be amended because of changes in the description or reporting of critical audit matters. In principle, auditors should approach errors and misstatements in the communication of critical audit matters 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.⁵⁶ It appears that under current practice, SEC filings have been amended solely to correct errors in auditor's reports, such as incorrect auditor's report dates or missing explanatory paragraphs.

Another commenter expressed concern that management may be asked to respond to investor questions regarding issues described in critical audit matters and may not be in a position to do so, particularly in light of their responsibilities under Regulation FD. Given the auditor's responsibility to communicate with the audit committee, and the likelihood of extensive discussions between auditors and management regarding critical audit matters, it seems likely that management will be prepared to respond appropriately and in compliance with their legal obligations (including Regulation FD), as they would with regard to any other question about information included in an SEC filing.

d. Ability to Communicate No Critical Audit Matters

The reproposal provided that the auditor could determine there were no critical audit matters and provide a statement to that effect in the auditor's report. Commenters

⁵⁶ The final 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.

generally supported the auditor's ability to determine that there are no critical audit matters. Two commenters suggested that the auditor should not have to make a statement in the auditor's report that there were no critical audit matters because the absence of a critical audit matter should be sufficient without the definitive statement, similar to an emphasis paragraph. The final standard includes the possibility that the auditor could determine, and state in the auditor's report, that there are no critical audit matters.⁵⁷ The statement that there are no critical audit matters is required because unlike an emphasis paragraph, critical audit matters are a required element of the auditor's report.

The determination of critical audit matters is 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 applies, the auditor will 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 will 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.⁵⁸ 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.⁵⁹

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

⁵⁷ Since communication of critical audit matters will not be required for the audits of EGCs, brokers and dealers reporting under Exchange Act Rule 17a-5, 17 CFR 240.17a-5, investment companies other than business development companies, and benefit plans, the auditor's report for the audits of these entities will not be required to include the statement that there are no critical audit matters.

⁵⁸ See paragraph 13 of ISA 701.

⁵⁹ See paragraphs 14 and 16 of ISA 701.

response to the risks; and (3) where relevant, key observations arising with respect to the risks.⁶⁰

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.⁶¹ 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 expressed in standardized language; and (3) complements the description of significant issues required to be made by the audit committee.⁶²

3. *Documentation of Critical Audit Matters*

The repropoed standard required documentation of 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. Some commenters supported a documentation requirement only for matters that were determined to be critical audit matters. Some of these commenters asserted that documentation about matters determined not to be critical audit matters would add costs and primarily benefit PCAOB inspections rather than audit quality. Others stated that the requirement is not aligned with the IAASB's documentation requirement, which, in their view, focuses on rationale for inclusion as a key audit matter rather than exclusion. However, another commenter argued that the determination that a matter was not a critical audit matter would seem to be an important audit judgment that ought to be documented for review by the engagement quality reviewer. This commenter suggested that documentation be required only for matters required to be communicated to the audit committee (which would already have been documented) and not for those that are communicated otherwise. One auditor argued that the repropoed requirement would lead auditors to document all audit committee communications even if not required, and that this would disproportionately

⁶⁰ See requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

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

⁶² See paragraph 19B of UK ISA 700 (2013).

affect smaller companies whose audit committees more commonly request information not required to be communicated under PCAOB standards.

The final standard substantially retains the approach from the reproposal of requiring the auditor to document the basis for determining critical audit matters.⁶³ The objective of the requirement is to document how the determination of critical audit matters (or the determination that there are no critical audit matters) was made from among the matters communicated or required to be communicated to the audit committee that relate to accounts or disclosures that are material to the financial statements. The documentation requirement will also facilitate review by the engagement quality reviewer.⁶⁴

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 a single sentence will be sufficient. This situation may arise, for instance, when the auditor's documentation prepared in the course of the audit includes sufficient detail about whether or not the matter involved especially challenging, subjective, or complex auditor judgment. Other matters may require more extensive documentation.

As noted in the reproposing release, for matters determined to be critical audit matters, the description in the auditor's report (which, among other things, must describe the principal considerations that led the auditor to determine that it was a critical audit matter) will generally suffice as documentation.

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 or not 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.

⁶³ The language of the documentation requirements has been redrafted to improve clarity, based on a commenter's suggestion.

⁶⁴ Under the existing audit documentation requirements, 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, *Audit Documentation*.

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.⁶⁵ The EU does not include documentation requirements for expanded auditor reporting. The FRC does not include specific documentation requirements related to expanded auditor reporting.⁶⁶

4. Liability Considerations Related to Critical Audit Matters

In both the proposal and the reproposal, the Board acknowledged that including critical audit matters would change the auditor's report in ways that could affect auditors' potential liability. As discussed in those releases, 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 critical audit matters would themselves be new statements that could be the basis for asserted claims. In addition, information provided regarding critical audit matters could affect other aspects of securities fraud claims against either the issuer, the auditor, or both (for example, by being described in pleadings in an effort to plead fraud with particularity or as a basis to seek to undercut a claim of reliance). 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.

A number of companies and accountants responded to this request for comment. While several of these commenters noted that changes from the proposal had addressed certain of their liability concerns, most continued to express varying degrees of concern about the potential for increased liability, either for auditors or for both auditors and companies.

In particular, commenters expressed concern that investors who suffer a financial loss could assert legal claims against the auditor based on statements made in identifying and describing critical audit matters. As with the proposal, commenters expressed general concerns that communication of critical audit matters would encourage baseless litigation, would likely lead to increased audit fees, raise the

⁶⁵ See paragraph 18(a) of ISA 701.

⁶⁶ General documentation requirements appear in ISA (UK and Ireland) 230, *Audit Documentation*.

settlement value of spurious claims, or potentially undermine the stringent pleading standards of the Private Securities Litigation Reform Act of 1995, which were intended to curtail non-meritorious claims against auditors and avoid the costs and burdens associated with them. Some commenters argued that auditors, to avoid being second-guessed, would have the incentive to communicate matters to the audit committee that were not otherwise required or to identify too many critical audit matters in an effort to protect themselves from liability. Several commenters expressed concern that communicating critical audit matters might compromise their ability to argue that the statements in the audit report are opinions which, one commenter argued, were "less vulnerable to challenges that they are false or misleading."⁶⁷ However, at least one of these commenters noted that the revised definition of a critical audit matter in the reproposal mitigated their concern on that point. Other commenters argued that the information communicated in describing critical audit matters could potentially be used to attack the audit by challenging the procedures performed or the adequacy of audit evidence obtained by the auditor. On the other hand, one commenter noted that the communication of critical audit matters is about disclosure of risks and challenges and expressed the belief that non-communication of such matters would be more problematic from a litigation point of view.

Some commenters argued that the risk of liability would be heightened if the auditor were providing original information about the company. In particular, several commenters contended that doing so would conflict with accountants' professional obligation to maintain client information in confidence, which could give rise to claims by the company against the auditor under state law.

Some commenters argued that critical audit matters could 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, could be misinterpreted as acts of negligence on the part of the company, or could be used by plaintiffs as a "road map" for litigation against the company. One commenter argued that, because the underlying work papers are subject to discovery, critical audit matters would be used as a source for potential litigation against both auditors and companies.

Some of the commenters that expressed concerns about the potential for increased auditor liability also suggested changes to the reproposal that they maintained would reduce the liability impact of determining and communicating critical audit matters. For example, as previously discussed, several commenters suggested substantially similar changes to modify the materiality component of the definition of

⁶⁷ Letter from PricewaterhouseCoopers LLP (Aug. 15, 2016) at 7, available on the Board's website in Docket 034.

critical audit matters and to prohibit or discourage auditor communication of original information.⁶⁸

The Board has carefully considered commenters' concerns about potential liability throughout this standard-setting process, including the comments received on the reproposal. While mandating disclosure of critical audit matters will, by design, entail new statements in the auditor's report, the Board notes that any claim based on these new statements would have to establish all of the elements of the relevant cause of action (for example, when applicable, loss causation and reliance). Critical audit matters will not replace or alter the fundamental requirement that the auditor's report include the auditor's opinion that the financial statements are fairly presented in accordance with the applicable financial reporting framework, which has been, and the Board expects will continue to be, the primary statement at issue in most private securities litigation under federal law involving auditors.

Throughout this standard-setting process, the Board has carefully considered commenters' suggestions to alter the terms of its proposal to mitigate their concerns about potential liability for omitting a critical audit matter. As discussed in the reproposal, the Board limited and clarified the process for determining critical audit matters, including by narrowing the source of critical audit matters to matters communicated or required to be communicated to the audit committee, adding a materiality component to the critical audit matter definition, and refining the factors used to determine critical audit matters. Those changes, as well as the critical audit matter definition's focus on the auditor's judgment, should mitigate concerns about potential liability for omitting a critical audit matter. With respect to suggestions to further narrow the definition of critical audit matters and the related communication requirements, it is not clear, and commenters did not explain, how those changes would mitigate liability concerns other than by reducing the number and content of required communications of critical audit matters. As described above, the Board has determined not to incorporate those suggested changes because they appear likely to significantly reduce the number of potential critical audit matters and the informativeness of auditor communication of critical audit matters.

With respect to potential state law claims by companies against their auditors for disclosing original information, the Board notes that, as discussed above, it does not expect that, in general, critical audit matters will provide sensitive information that has not been disclosed by the company. With respect to the potential for a claim based on a situation in which the auditor found such disclosure necessary, the Board notes that auditors already have preexisting duties to disclose original information in certain

⁶⁸

See discussion at Sections IV.A.1.a.ii and IV.A.2.c above.

circumstances.⁶⁹ Commenters did not cite any specific examples in which these requirements have resulted in unwarranted claims against auditors for disclosing client confidences. Because the auditor's obligations under PCAOB standards arise under federal law and regulations, professional or state law duties of client confidentiality should not apply to,⁷⁰ or should be preempted by,⁷¹ the obligation to communicate critical audit matters.⁷²

While the Board takes seriously the prospect of potential increases in auditors' or companies' liability, the Board believes it has appropriately addressed commenters' concerns regarding liability in a manner compatible with the objectives of this

⁶⁹ For example, for at least the last 20 years, auditors have had duties to disclose in their auditor's reports when they have substantial doubt about the company's ability to continue as a going concern. See Section 10A of the Exchange Act and AS 2415. In addition, when in an audit of internal control over financial reporting, the auditor identifies a material weakness that has not been included in management's assessment, the auditor must modify its report to, among other things, "include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements . . .". See Note to paragraph .91 of AS 2201; *cf.* Statement of Gaylen R. Hansen, CPA, at the PCAOB public meeting (Apr. 2, 2014) ("Client confidentiality has a long-standing and important place in the accountancy profession. However, it doesn't serve investors well when it is parlayed to obfuscate the important obligation to call things as they are seen.").

⁷⁰ For example, the relevant AICPA rule provides that auditors "shall not disclose any confidential client information without the specific consent of the client," but further provides that the confidentiality obligation shall not be construed "to prohibit . . . compliance with applicable laws and government regulations." See paragraphs .01 and .02 of 1.700.001 *Confidential Client Information Rule* of the AICPA Code of Professional Conduct (as of Dec. 15, 2014).

⁷¹ See *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000); *New York v. FCC*, 486 U.S. 57, 64 (1988).

⁷² Some commenters suggested that safe harbor rules be created to protect auditors and companies from liability for statements about critical audit matters. While, as noted above, the Board will monitor the effects of critical audit matters should the requirements be approved by the SEC, the Board is not convinced at this time that any such safe harbor is necessary and, in any event, such a safe harbor is beyond the Board's authority.

rulemaking, and in view of the rulemaking's anticipated benefits. Indeed, the Board notes that at least one of the commenters that expressed concern about potential liability, noted that those concerns "should not stand in the way of moving forward" on the repropoed standard.⁷³ At the same time, the Board acknowledges that a variety of claims can be raised related to the statements in the audit report and that litigation is inherently uncertain. If the final standard is approved by the SEC, the Board will monitor the standard after implementation for any unintended consequences.

B. Additional Improvements to the Auditor's Report

The reproposal provided a list of basic elements to be included in every auditor's report. Some of these basic elements, such as auditor tenure, would be new elements in the auditor's report. Other 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.⁷⁴ Yet other basic 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.

1. Auditor Tenure

The reproposal included a required statement in the auditor's report of the year the auditor began serving consecutively as the company's auditor. The Board also sought comment on whether auditor tenure should be disclosed in Form AP, *Auditor Reporting of Certain Audit Participants* ("Form AP"), rather than in the auditor's report.⁷⁵

a. Disclosure of Tenure

Investor commenters stated that information regarding auditor tenure would be useful to financial statement users, for example, in deciding whether to vote to ratify the appointment of the auditor. Investors that expressed a preference supported tenure

⁷³ See letter from Deloitte & Touche LLP (Aug. 12, 2016) at 5, available on the Board's website in Docket 034.

⁷⁴ See existing AS 3101.06–.08.

⁷⁵ In December 2015, the Board adopted Form AP, which provides investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. 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).

disclosure in the auditor's report, some on the basis of reducing investor search costs by ensuring a consistent location for the disclosure. One commenter representing a group of investors asserted that since the auditor's report is the primary means by which the auditor communicates with investors, it is appropriate for auditor tenure to be included in the auditor's report. This commenter further stated that disclosure of auditor tenure on Form AP would be an acceptable alternative to disclosure in the auditor's report only if the timeliness, accessibility, searchability, and overall functionality of the information disclosed on Form AP were at least equivalent to having the information disclosed in the auditor's report. Another commenter suggested that, if disclosure were required in the auditor's report, a specific location should be designated.

Currently, information about auditor tenure is not required to be communicated to investors by the auditor, management, or the audit committee.⁷⁶ However, there is a growing trend toward voluntary disclosure of auditor tenure. Recent analysis of corporate proxy statements for annual meetings of shareholders has found that a growing number of companies are disclosing auditor tenure,⁷⁷ presumably due to interest from investors. However, voluntary disclosure is not provided for a significant number of audits subject to the Board's jurisdiction. Additionally, if disclosed, such information may not be provided in the same location in the proxy statement; for

⁷⁶ In certain instances, investors may be able to manually calculate tenure by reviewing company filings on the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") to determine when a company changed auditors. However, the information is not available prior to 1994 and may not be available for certain entities, such as investment companies and brokers and dealers, that are not required to file Form 8-K. See 17 CFR 249.308, Item 4.01 *Changes in Registrant's Certifying Accountant*. Accordingly, currently available information is neither complete nor a readily accessible alternative to auditor tenure disclosure.

⁷⁷ The Center for Audit Quality, together with Audit Analytics, reviewed corporate proxies filed through the end of June 2016, 2015, and 2014 of 1,500 Standard and Poor's ("S&P") Composite companies. Their analysis identified that in 2016, 2015, and 2014 auditor tenure was disclosed in the annual proxy statements of 59, 54, and 47 percent of the S&P 500 large-cap companies, respectively, 45, 44, and 42 percent of the S&P MidCap 400 companies, respectively, and 48, 46, and 50 percent of the S&P SmallCap 600 companies, respectively. See Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016). Separately, during their review of proxy statements of Fortune 100 companies, Ernst & Young identified that 63 percent of the companies reviewed voluntarily disclosed auditor tenure in 2016 compared to 62 percent in 2015, 51 percent in 2014, 29 percent in 2013, and 24 percent in 2012. See Ernst & Young, *Audit Committee Reporting to Shareholders in 2016* (Sept. 2016).

instance, some disclosures are in the audit committee report while others are in another section of the proxy.⁷⁸ Further, the proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, many companies whose securities are not listed on a national securities exchange, and most investment companies are not required to prepare proxy statements.

Some commenters, primarily companies, did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors. Other companies and accounting firms raised a concern that tenure disclosure could result in inferences that, in their view, would be inappropriate about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. Some commenters also suggested that auditor tenure is a corporate governance matter and that disclosure should be provided by management or the audit committee rather than the auditor. A few commenters suggested that tenure disclosure should be addressed by SEC rulemaking or provided only voluntarily. Some commenters, many of whom generally opposed auditor tenure disclosure, suggested that Form AP would be a preferable location for disclosing tenure if the Board proceeded with requiring the disclosure.

The SEC's Investor Advocate stated that he "strongly support[s] requirements for public disclosure of auditor tenure," recognizing that there were different opinions about the best party and location to make that disclosure.⁷⁹ Noting that the SEC had issued a concept release asking whether auditor tenure should be disclosed in the audit committee report,⁸⁰ the SEC's Investor Advocate stated that he believed the SEC should ultimately decide these questions. In light of these considerations, the SEC's Investor Advocate recommended that the PCAOB act to require disclosure of auditor tenure (either in the auditor's report or in Form AP), but also consider including a contingent sunset clause such that the auditor disclosure requirement would expire if and when the SEC imposed any form of a company disclosure requirement.

⁷⁸ See Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016).

⁷⁹ See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 4, available on the Board's website in Docket 034. The letter noted that the views of the Investor Advocate do not necessarily reflect the views of the SEC, the Commissioners, or staff of the SEC, and the SEC disclaims responsibility for the letter and all analyses, findings, and conclusions contained therein. Additional information about the Office of the Investor Advocate is available on the SEC's website.

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

The Board believes that public disclosure of auditor tenure is important and in the public interest, and that it is appropriate to require disclosure in the auditor's report because it is the primary means by which auditors communicate with investors. This will ensure that the disclosure is in a readily accessible and consistent location—the auditor's report—for all companies. It will make auditor tenure information immediately available to investors upon filing with the SEC of a document containing the auditor's report. Disclosure of auditor tenure in the auditor's report will also reduce search costs for investors who are interested in auditor tenure, relative to the current environment of voluntary reporting. Disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The Board is not persuaded by commenters' concerns that disclosure of auditor tenure in the auditor's report necessarily suggests a specific correlation between auditor tenure and audit quality, or between auditor tenure and auditor independence. In the Board's view, auditor tenure is another data point about the auditor, in addition to the firm name and the office issuing the auditor's report, for which there is demonstrable investor demand.

The standard does not specify a required location within the auditor's report for the statement on auditor tenure; auditors that are concerned about the inferences readers may draw based on the placement of the disclosure in the auditor's report have discretion to present auditor tenure in the part of the auditor's report they consider appropriate. Consistent with the reproposal, the illustrative auditor's report in the final standard includes the statement on auditor tenure at the end of the report.

The Board considered disclosure of auditor tenure in Form AP, which requires disclosure of the name of the engagement partner and of the names and percentage of participation of other accounting firms in the audit for all issuer audits. Form AP was developed primarily to respond to commenter concerns about the potential liability consequences of naming persons in the auditor's report, the potential need to obtain consents from those named persons in connection with registered securities offerings, and the additional time needed to compile information about the other accounting firms. The Board's determination to require disclosure in Form AP, rather than in the auditor's report, was a means to address these concerns. Disclosure of auditor tenure does not have the same potential liability or other consequences as disclosure of the name of the engagement partner or other accounting firms, so such an approach is unnecessary in this case.

The Board acknowledges that the SEC, given its broader authority and responsibility for the financial reporting process, could in the future determine that auditor tenure should be disclosed by some other party or in some other location, in addition to or instead of in the auditor's report. Accordingly, the Board is adopting its requirement for tenure disclosure in the auditor's report today. The Board anticipates

that, if the SEC undertook rulemaking for disclosure of auditor tenure, the Board would work with the SEC to ensure that PCAOB standards coordinate appropriately with any new SEC requirements.⁸¹

b. Determination of Tenure

The reproposal contemplated that tenure would be calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure, and it included a note providing that if the auditor is uncertain as to the year the auditor became the company's auditor, the auditor should so state and provide the earliest year of which the auditor has knowledge. Some commenters objected to this approach, saying that it could confuse investors and its relevance is unclear. The Board believes that the disclosure of tenure should reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit. No changes have been made to the note in the final standard.

Additionally, if a company went public and maintained the same auditor, auditor tenure will include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Because of the unique structure of investment companies, which typically includes common accounting, internal control, and oversight functions at the group level, the reproposed standard required that, for an investment company that is part of a group of investment companies,⁸² the auditor's statement regarding tenure will contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies.⁸³ For example, if Firm A has been

⁸¹ Of course, the SEC also has authority to abrogate or modify PCAOB rules at any time, to, among other things, further the purposes of the securities laws. Section 107(b)(5) of Sarbanes-Oxley, 15 U.S.C. 7217(b)(5).

⁸² A group of investment companies, as defined by Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"), means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. For purposes of determining auditor tenure, any tenure with other entities that may be part of an investment company complex, such as investment advisers or private investment companies, is not included.

⁸³ The following is an example of such statement: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

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, will state that Firm A has served as the auditor of one or more XYZ investment companies since 1980.

A commenter asserted that measuring auditor tenure from the first year of service to the group of investment companies might confuse or even mislead the reader of the auditor's report for a new fund, especially if the auditor has served the group for several years. Another commenter supported the repropoed methodology for measuring tenure for investment companies stating that it is appropriate given the common accounting system, system of internal control over financial reporting, and board oversight for a group of investment companies.

After considering the comments received, the Board is adopting the requirement regarding auditor tenure for an investment company that is part of a group of investment companies as repropoed. The Board believes that the length of an auditor's relationship with the group is more relevant than the relationship with an individual fund, since funds can be started and merged over time but the auditor's relationship with the group continues.

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.⁸⁴ The IAASB and the FRC do not include a similar requirement.

2. Clarification of Existing Auditor's Responsibilities

The repropoed standard 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 repropoed standard included a requirement intended to promote uniformity with respect to the addressee of the report.

⁸⁴ See requirements in 2(b) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

a. Auditor Independence

The repropoed standard included a required 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 SEC⁸⁵ and the PCAOB.⁸⁶

Commenters generally supported the required statement regarding auditor independence. Some said that the statement would reinforce financial statement users' understanding of the auditor's existing obligations to be independent and serve as a reminder to auditors of these obligations. Some commenters preferred a more definitive statement, such as stating that the auditor is in fact independent and in compliance with applicable independence rules. A few commenters questioned whether the statement will improve an investors' understanding of the auditor's independence responsibilities, yield any incremental benefits or insight to investors, or have any impact on auditor behavior. Some of these commenters pointed out that independence is already included in the title of the auditor's report and including an additional statement in the auditor's report is redundant and unnecessary.

After consideration of comments, the statement regarding auditor independence is adopted as repropoed. The Board believes that the independence statement in the auditor's report will 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 will 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.⁸⁷ The EU requires a statement in the auditor's report that the auditor remained independent of the audited entity in conducting the audit.⁸⁸ The FRC

⁸⁵ See Regulation S-X Rule 2-01, 17 CFR 210.2-01.

⁸⁶ See PCAOB Rule 3520, *et seq.*

⁸⁷ See paragraph 28(c) of ISA 700.

⁸⁸ See requirements in 2(f) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

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.⁸⁹

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.⁹⁰ 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.⁹¹

To promote consistency in addressing the auditor's report to the company's investors, the repropoed standard included a requirement for the auditor's report to be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The repropoed standard stated that the auditor's report may include additional addressees.

Commenters generally supported the addressee requirement as repropoed stating that it is appropriate and will create consistency in practice. A commenter suggested limiting the required addressees to the shareowners of corporations or equivalents for companies not organized as corporations because investors are the key customers of the auditor's report. A few commenters stated that the auditor's report is intended for general use and the requirement for the auditor's report to be addressed to a specific party is not necessary.⁹¹ A commenter expressed concern that retaining the option for the auditor's report to be addressed to third parties could inadvertently result in increased auditor liability and cost.

In response to comments, and to promote greater uniformity in the addressees of the auditor's report, the Board is adopting the addressee requirement as repropoed. Since inclusion of additional addressees is voluntary, auditors could assess, based on the individual circumstances, whether or not to include additional addressees in the auditor's report. In addition, the Board believes that it is appropriate for the auditor's

⁸⁹ See paragraph 15 of UK ISA 700 (2013).

⁹⁰ See existing AS 3101.09.

⁹¹ 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.

report to be addressed to the board of directors and not just to the shareholders, because of the role of the board of directors in the governance of the company.

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.⁹² The EU does not specify the addressee of the auditor's report. The FRC requires that the auditor's report be addressed as required by the circumstances of the engagement.⁹³ UK auditor's reports are typically addressed to either the members or the shareholders of the company.⁹⁴

c. Other Enhancements to the Basic Elements

The reproposal would have changed the language for certain elements in the existing auditor's report. These 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.⁹⁵ 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 financial statements are free of material misstatements, whether caused

⁹² See paragraph 22 of ISA 700.

⁹³ See paragraph 13 of UK ISA 700 (2013).

⁹⁴ See paragraph A5 of UK ISA 700 (2013).

⁹⁵ The final standard uses 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 Regulation S-X Section 1-01(b), 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 final standard will not apply to schedules included as supplemental information, as defined in AS 2701, *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.

by error or fraud.⁹⁶ 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:
 - 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;
 - Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
 - Evaluating the accounting principles used and significant estimates made by management; and
 - Evaluating the overall presentation of the financial statements.

Commenters generally supported the repropoed language for these basic elements of the auditor's report. These elements are adopted as repropoed.

3. *Additional Basic Elements Suggested by Commenters*

In addition to the changes proposed by the Board, commenters on the repropoal suggested additional elements to be included in the auditor's report.

Several commenters suggested that the PCAOB consider additional standardized language in the auditor's report to describe the responsibilities of the auditor, management, and the audit committee. In doing so, some of these commenters suggested that the PCAOB consider additional language adopted by the IAASB, in order to promote consistency in reporting and to help users understand more fully the separate responsibilities of each of the parties with respect to the audited financial statements. In contrast, another commenter cautioned that a thorough description of everyone's roles and responsibilities would further add to repetitive boilerplate language. This commenter suggested instead that the auditor's report provide a cross reference to a more complete description of the roles and responsibilities of the auditor, management, and the audit committee. This commenter did not indicate where such cross-referenced material would appear. Given little interest from investors in such

⁹⁶ See paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

additional language during the Board's initial outreach and the risk that it would be boilerplate, the final standard does not include these additional elements.

Two accounting firms suggested describing the meaning of reasonable assurance. The final standard requires a statement in the "Basis for Opinion" section of the auditor's report that the auditor "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The auditing standards describe reasonable assurance as a high level of assurance, although not absolute assurance.⁹⁷ During the Board's initial outreach such additional language was considered, but there was no investor demand for it. As a result, the final standard does not expand the description of reasonable assurance in the auditor's report.

Some commenters also suggested that the auditor's report should include disclosure of the materiality measures used by auditors in planning the audit. These commenters asserted that it could help inform investors' proxy voting process for auditor ratification, as such disclosure could be a valuable supplement to an audit fee analysis and used to compare materiality over time to trends in restatements and adjustments. These commenters also observed that materiality disclosures are provided in the auditor's reports in the U.K. 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.⁹⁸ One commenter opposed a disclosure of materiality on the basis that it may encourage disclosure of quantitative materiality levels and ignore qualitative aspects of materiality, which cannot be described in a meaningful way in the auditor's report. The Board has decided not to include this additional element in the auditor's report at this time because disclosure may reduce the element of surprise in the audit and overstate the importance of quantitative rather than qualitative factors in the auditor's overall consideration of materiality. However, the Board will monitor the implementation of the final standard, as well as the developments of expanded auditor reporting in other jurisdictions, to determine if future enhancements to the auditor's report may be warranted in this area.

Additionally, some commenters suggested that the auditor's report should define the auditor's responsibility for other information in documents containing audited financial statements so that financial statement users have a clear understanding. The Board's proposal included another new auditing standard, *The Auditor's Responsibilities*

⁹⁷ Paragraph .10 of AS 1015, *Due Professional Care in the Performance of Work*.

⁹⁸ See PCAOB Release No. 2011-003, Appendix C, for a detailed discussion of the staff's outreach regarding reporting materiality levels.

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. The Board has not taken any further action since the proposal.

A few commenters suggested including other elements, such as the date when the auditor completed fieldwork, a statement that the auditor looked for material fraud, disclosure when alternative dispute resolution clauses are included in engagement letters, and disclosure of reasons for change in the engagement partner prior to mandatory rotation. The final standard does not include these elements because the Board believes they would not add meaningfully to the information already provided in the final standard or the elements go beyond what was considered in this standard-setting project and, thus, the Board is not including these elements at this time.

C. Explanatory Language and Emphasis of a Matter

1. Explanatory Language Required by Other PCAOB Standards

The repropoed standard, similar to the existing standard,⁹⁹ provided a list of circumstances in which the auditor is 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 included 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.

The list of circumstances from the Board's reproposal did not attract much comment, although one commenter affirmed support for including the list. Commenters on the Board's proposal supported providing a list in the standard of the 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 final standard includes the list of explanatory paragraphs and related references as repropoed.

The repropoed standard included a requirement for the auditor to add explanatory language in cases where the company is required to report on ICFR but has determined that it is not required to obtain, and did not request the auditor to perform, an audit of ICFR.¹⁰⁰ The repropoed standard included a reference to a new

⁹⁹ See existing AS 3101.11.

¹⁰⁰ 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

proposed requirement in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the auditor to add such explanatory language. Some commenters were supportive of the repropoed requirement, while one commenter did not believe such a requirement was necessary but did not object to its inclusion.

The Board also sought comment on whether the requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR should 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. Several commenters supported expanding the requirement to all instances in which the auditor is not engaged to opine on ICFR, and not limit it to only when management is required to report on ICFR.

In the Board's view, it is appropriate to add explanatory language to the auditor's report when management has a reporting responsibility on ICFR but the auditor is not engaged to opine on ICFR, in order to clarify the auditor's responsibilities in this situation. For companies for which management is not required to report on ICFR, the Board does not believe that the auditor should have a separate reporting responsibility. Accordingly, the final standard retains the requirement as repropoed.¹⁰¹ The auditor may, however, choose to include such a paragraph in the auditor's report voluntarily.

Interaction between critical audit matters and explanatory paragraphs. The repropoed standard clarified 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, the repropoal contemplated that both the explanatory paragraph and the required communication regarding the critical audit matter would be provided. The auditor could include the communication required for 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 could 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.¹⁰² While the information reported in a critical audit matter may overlap with

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 nonaccelerated filers and emerging growth companies, are not subject to Section 404(b).

¹⁰¹ See amendments to AS 3105.59–.60.

¹⁰² When both an explanatory paragraph and a critical audit matter communication are provided, the critical audit matter description should not include

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.

Commenters were generally supportive of the interaction between the communication of critical audit matters and required explanatory paragraphs as described in the repropoed standard. Some alternative views, however, were expressed. One commenter thought that if a required explanatory paragraph is also a critical audit matter, disclosure in the auditor's report should be limited to one place in the auditor' report. The commenter suggested that the communication requirements for both a critical audit matter and an explanatory paragraph be reported in the critical audit matter section of the auditor's report with a cross reference in the explanatory paragraph section. Another commenter suggested that the PCAOB harmonize its approach with that of the IAASB, which requires a reference in the key audit matter section but waives the requirements to describe the key audit matter and how it was addressed during the audit. Finally, another commenter thought that critical audit matter communications should not be permitted to be integrated with explanatory paragraphs, on the basis that explanatory paragraphs are about matters in the financial statements to which the auditor wants to draw the reader's attention and are not necessarily critical audit matters.

The final standard retains the interaction between critical audit matters and explanatory paragraphs as repropoed. The approach provides flexibility on auditor disclosure, yet also ensures that the communication requirements are met.

2. *Emphasis of a Matter*

The repropoed standard, 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").¹⁰³ 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.

The repropoed standard provided a list of potential matters that the auditor may emphasize in the auditor's report, although the auditor may also decide to emphasize other matters.

conditional language that would not be permissible in the explanatory paragraph. See footnote 5 of AS 2415.

¹⁰³ See existing AS 3101.19.

Commenters were supportive of emphasis paragraphs as described in the repropounded standard and did not suggest any additional matters to be included in the list of potential emphasis paragraphs. The final standard includes emphasis paragraphs as repropounded.

Interaction between critical audit matters and emphasis paragraphs. The repropounded standard stated that emphasis paragraphs are not a substitute for required critical audit matters. If a matter that the auditor considers emphasizing meets the definition of a critical audit matter, the auditor would provide the information required for critical audit matters, and would not be expected to include an emphasis paragraph in the auditor's report. Although this did not generate much comment, one commenter affirmed support for the interaction between critical audit matters and emphasis paragraphs. The final standard retains the interaction between critical audit matters and emphasis paragraphs as repropounded.

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 repropounded 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.¹⁰⁴ Under the IAASB's approach, an emphasis of matter paragraph is not required for a matter that was determined to be a key audit matter.¹⁰⁵ 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.¹⁰⁶ The IAASB, FRC, and EU do not have requirements for reporting on ICFR.

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

¹⁰⁴ See paragraph A1 of ISA 570, *Going Concern*, and paragraph 15 of ISA 701.

¹⁰⁵ See paragraph 8 of ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

¹⁰⁶ 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 (Apr. 16, 2014).

investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.¹⁰⁷ 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 information in the auditor's report.¹⁰⁸ The final 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 final standard requires 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.¹⁰⁹ Under EU law, the engagement partner is required to sign the audit report in all EU countries, including the United Kingdom.¹¹⁰ 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 reproposed standard required 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 did not specify an order for the remaining sections of the auditor's report, which would include explanatory paragraphs and critical audit matters. This approach allowed 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 also required 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.

¹⁰⁷ See PCAOB Release No. 2015-008.

¹⁰⁸ When the auditor divides responsibility for the audit under AS 1205, *Part of the Audit Performed by Other Independent Auditors*, the auditor's report must acknowledge the involvement of the other auditor.

¹⁰⁹ See paragraph 45 of ISA 700.

¹¹⁰ Directive 2006/43/EC of the European Parliament and of the Council, Article 28, *Audit Reporting* (May 17, 2006).

Commenters were generally supportive of the proposed changes to the form of the auditor's report, because the changes will:

- Enhance the clarity and comparability of disclosures;
- Make it easier for investors to find the opinion since it will be listed first;
- Help facilitate a comparison between auditor's reports; and
- Allow for an appropriate level of flexibility and ease of use without being overly prescriptive.

Some commenters suggested the PCAOB should be consistent with other standard setters in the ordering of section titles in the auditor's report. One commenter expressed concern that the ordering of the components of the opinion and the heading of the critical audit matter section of the report may be misunderstood to imply that critical audit matter communications are separate and distinct from the auditor's opinion, which could be misinterpreted as a piecemeal opinion. In light of the commenter support described above, the Board is adopting the form of the auditor's report as repropoed. As previously discussed, the final standard includes revised introductory language in the auditor's report to avoid the potential misperception that the communication of critical audit matters provides piecemeal opinions.

Requirements of Other Regulators and Standard Setters

The repropoed approach with respect to the order of the sections of the auditor's report is generally consistent with that of the IAASB.¹¹¹ The EU and FRC do not specify an order to the auditor's report.

F. Application to Other Audits Performed Under PCAOB Standards

There are situations in which an auditor may be required by law or regulation, or voluntarily agrees, to perform an audit engagement in accordance with PCAOB standards for a company whose audit is not subject to PCAOB oversight.¹¹² For

¹¹¹ See paragraphs 23–28 of ISA 700.

¹¹² Under the Sarbanes-Oxley Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB oversees the audits of "issuers" and brokers and dealers reporting under Exchange Act Rule 17a-5. See Sarbanes-Oxley Act Section 101. An "issuer" under the Sarbanes-Oxley Act is an entity whose securities are registered under Section 12 of the Exchange Act, or that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed

example, SEC rules permit audits under PCAOB standards in connection with offerings under Regulation A and Regulation Crowdfunding.¹¹³ In these situations, certain elements of the auditor's report required under the final standard, such as the use of "registered public accounting firm" in the title or the statement regarding independence requirements, may not apply. Additional guidance for these situations will be provided.

V. Amendments to Other PCAOB Standards

The Board is adopting amendments to several of its existing auditing standards solely to conform to the final standard.¹¹⁴ The Board is not adopting 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 redesignated standard AS 3105, may need further updating. The Board may consider proposing further changes to these standards under separate standard-setting projects.

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

Existing AS 3101.10 and .20-.76 address departures from the auditor's unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion, and other reporting circumstances, such as reporting on comparative financial statements. These paragraphs are redesignated as AS 3105.¹¹⁵ Commenters who addressed this topic generally supported the repropoed amendments to AS 3105, including amending the example auditor's reports to conform with the example auditor's report in the final standard. The Board also received some comments suggesting further changes to AS 3105, such as updating descriptions of and references to accounting requirements that are no longer current¹¹⁶ and updating certain terminology (e.g.,

a Securities Act registration statement that has not yet become effective and that it has not withdrawn. See Sarbanes-Oxley Section 2(a).

¹¹³ See Securities Act Form 1-A, Part F/S (b)(2) and (c)(1)(iii); Regulation Crowdfunding Rule 201(t) instruction 9, 17 CFR 227.201(t).

¹¹⁴ The amendments are included in Appendix 2.

¹¹⁵ AS 3101.01-.09 and .11-.19 are amended and restated as provided in Appendix 1.

¹¹⁶ The Board has issued guidance regarding the status of outdated descriptions of and references to U.S. GAAP in PCAOB standards. See PCAOB, *Staff Questions and Answers, References to Authoritative Accounting Guidance in PCAOB Standards* (Sept. 2, 2009). Among other things, this guidance provides that auditors

changing references from "entity" to "company"). The Board may consider such updates as part of a separate standard-setting project.

The Board is adopting final amendments to AS 3105 that are substantially similar to the reproposal. The amendments to AS 3105 are not intended to change the circumstances in which the auditor would depart from an unqualified opinion. The changes from the current standard will primarily: (1) require the communication of critical audit matters in certain circumstances; (2) revise certain terminology to align with the final standard; and (3) amend the illustrative reports for the basic elements of the final standard and the required order of certain sections of the auditor's report.

AS 3105 includes:

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

- a. *Qualified opinion*—Amendments to AS 3105 will require that when the auditor expresses a qualified opinion, the auditor's report also include communication of critical audit matters, if critical audit matter requirements apply.
- b. *Adverse opinion*—The existing requirements related to an adverse opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the adverse opinion.
- c. *Disclaimer of opinion*—The existing requirements related to a disclaimer of an opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the disclaimer of opinion.

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.¹¹⁷ However, in such

should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the FASB Accounting Standards Codification ("ASC").

¹¹⁷ See paragraph 15 of ISA 701.

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.¹¹⁸ 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.¹¹⁹ 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 amendments to other PCAOB standards are substantially as repropoed. These include:

- AS 1220, *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, *Communications with Audit Committees*—amending to require the auditor to provide to and discuss with the audit committee a draft of the auditor's report;
- AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*—amending the example auditor's report to conform with the example auditor's report on the financial statements in the final standard;
- AS 2820, *Evaluating Consistency of Financial Statements*—amending to include the existing reporting requirements and illustrative explanatory language related to a change in accounting principle or a restatement that is currently in AS 3105; and
- AS 4105, *Reviews of Interim Financial Information*—amending to include the basic elements of the final standard, where applicable.

¹¹⁸ *Id.*

¹¹⁹ See paragraph A7 of ISA 701 and paragraph 29 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

Conforming amendments were also made to every PCAOB standard that refers to the auditor's report. Commenters generally supported the amendments as repropoed.

A commenter suggested revising AS 3305, *Special Reports*, to conform to the example auditor's report in the final standard. Since reports pursuant to AS 3305 are rarely filed with the SEC, as noted by this commenter, the Board does not believe these reports should be updated at this time. As described above, the Board may consider updating this standard as part of a separate standard-setting project.

VI. Economic Considerations

The Board is committed to analyzing the economic impacts of its standard setting. The following discussion addresses the potential economic impacts, including potential benefits and costs, considered by the Board. The Board has sought information relevant to economic consequences several times over the course of the rulemaking. Commenters provided views on a wide range of issues pertinent to economic considerations, including potential benefits and costs, but did not provide empirical data or quantified estimates of the costs or other potential impacts of the standard. The potential benefits and costs considered by the Board are inherently difficult to quantify, therefore the Board's economic discussion is primarily qualitative in nature.

Commenters who discussed the economic analysis in the Board's reproposal provided a wide range of views. Some commenters pointed to academic research for the Board to consider in support of their views. One commenter asserted that the Board's release did not provide a true economic analysis of the pros and cons of mandating the reporting of critical audit matters, but only referenced academic studies on the purported benefits of such reporting. Another argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. The SEC's Investor Advocate said that the Board's economic analysis made a compelling case as to why the required reporting of critical audit matters would reduce informational asymmetries and add to the total mix of information available to investors.¹²⁰ The Board has considered all comments received and has sought to develop an economic analysis that evaluates the potential benefits and costs of the final standard, as well as facilitates comparisons to alternative Board actions.

¹²⁰ See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board's website in Docket 034.

A. Need for the Rulemaking

1. Critical Audit Matters

Generally, 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 asymmetry¹²¹ 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 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.¹²² 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.¹²³ 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. Some commenters on the reproposal have stated that investors would find information provided by the auditor, an independent third party, particularly relevant in this setting.

¹²¹ Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

¹²² See PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014).

¹²³ See IAASB Project Proposal, Revision of ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (Mar. 2016).

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, it provides very little of the information the auditor knows about the company, its financial reporting, and the challenges of the audit. 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.

The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments will help investors and other financial statement users "consume" the information presented in management's financial statements more effectively. Stated in economic terms, in the Board's view, an expanded auditor's report will 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. Reducing information asymmetry about the company's financial reporting should lead to a more efficient allocation of capital.

Some commenters supported the reporting of critical audit matters as a means of reducing the information asymmetry between investors and auditors. Other commenters disagreed with the Board's approach and questioned whether the Board could or should attempt to reduce information asymmetry by requiring expanded auditor reporting. The Board believes that requiring expanded auditor reporting as a means of reducing the information asymmetry between investors and auditors is consistent with its statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."¹²⁴ Investors are the intended beneficiaries of the audit, but investors do not receive information about specific work performed during the audit. The final standard seeks to enhance the form and content of the auditor's report to make it more relevant and informative to investors and other financial statement users.

¹²⁴

Section 101(a) of Sarbanes-Oxley.

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

The communication of critical audit matters will reduce the information asymmetry between investors and auditors by informing 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 auditor reporting of critical audit matters will provide investors with audit-specific information that should facilitate their analysis of the financial statements and other related disclosures. The communication of critical audit matters in the auditor's report should also help investors and analysts who are interested in doing so to engage management and the audit committee with targeted questions about these issues.¹²⁵ Ultimately, while not every critical audit matter will 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 additional insights on the financial statements.

The communication of critical audit matters should also assist investors in assessing the credibility of the financial statements and, in at least some instances, audit quality.¹²⁶ For example, the description of how the auditor addressed the critical audit matter will help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which should allow a deeper and more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have consistently stated that having the auditor rather than the company, provide this type of information would

¹²⁵ 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.

¹²⁶ It is often not possible to observe the difference between financial reporting quality and audit quality. An academic study conceptually models the path through which the financial reporting and audit processes result in audited financial reporting outcomes. The authors postulate that although audit quality and pre-audit financial reporting quality are distinct constructs, the two processes are often inseparable in terms of observable financial reporting outcomes in archival research. See Lisa Milici Gaynor, Andrea Seaton Kelton, Molly Mercer, and Teri Lombardi Yohn, *Understanding the Relation between Financial Reporting Quality and Audit Quality*, 35 *Auditing: A Journal of Practice & Theory* 1, 1-22 (2016).

be of added value to investment decision making.¹²⁷ Commenting on the reproposal, the SEC's Investor Advocate noted that investors want to hear directly from the auditor and that this point is confirmed by surveys of professional investors, as well as by certain academic research.¹²⁸ This commenter agreed with the premise in the reproposal that, because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility than information provided by management alone.

Reporting of critical audit matters should provide insights that will 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.

Many companies commenting on the reproposal argued that the reporting of critical audit matters would not increase the informativeness of the auditor's report. For example, several of these commenters claimed that the reporting of critical audit matters would simply duplicate management disclosure without adding additional information, or that critical audit matters would not provide value-relevant information. Other commenters asserted that the reporting of critical audit matters would result in the auditor's report becoming a lengthy list of boilerplate disclosures, which would contribute to disclosure overload or run contrary to the SEC's disclosure effectiveness initiative. Several commenters said that critical audit matters could confuse investors if the information in the auditor's report was duplicative of management's disclosures but was presented in a different manner, or if the critical audit matter presented information without appropriate context.

¹²⁷ See IAG 2011 survey and CFA survey and poll results.

¹²⁸ See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board's website in Docket 034 (citing 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)).

By contrast, investor commenters overwhelmingly agreed that the communication of critical audit matters would make the auditor's report more informative. One commenter said that, although critical audit matters in themselves would not provide investors with all the information needed in the face of growing financial complexity, critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies, form a multifaceted understanding of them, and make informed investment decisions. Another commenter noted that, in jurisdictions where the expanded auditor's report is available, it is one of the earliest elements of the company's annual report that they read because it typically highlights the more judgmental elements of the company's accounting, which often provides insights that form a basis for discussions with management.

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,¹²⁹ but in general these only point to a disclosure in the company's financial statements without providing any additional description of the matter and, as noted below, emphasis paragraphs are infrequent in practice. Auditor reporting about matters significant to the audit is not 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. For example, 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. Further, auditors may believe that providing additional information could potentially expose them to liability¹³⁰ or that doing so could be interpreted as a disclaimer of opinion or a partial opinion as to the identified matters. 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,¹³¹ and parties may also

¹²⁹ See existing AS 3101.19.

¹³⁰ Section IV.A.4 contains a discussion about potential auditor liability concerns stemming from expanded auditor reporting.

¹³¹ Academic research finds that there are certain situations in which

exhibit a bias toward the *status quo*.¹³² 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.

The Board believes that the required reporting of critical audit matters will promote more complete and consistent disclosure of audit-specific information to financial statement users who may be interested in it.¹³³ 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.¹³⁴

2. *Additional Improvements to the Auditor's Report*

The final standard requires auditors to disclose in the auditor's report the number of years they have served consecutively as the auditor for the company. Although some

disclosure may be socially optimal but not privately optimal. Auditors and companies may resist voluntary expanded auditor reporting because of concerns that certain 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, now known as the Office of Economic and Risk Analysis. The research cited above was published before he joined the PCAOB.

¹³² 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).

¹³³ 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).

¹³⁴ 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).

commenters dispute the value of this information, investor commenters have indicated that the length of the relationship between the auditor and the company would be a useful data point. The growing trend toward voluntary disclosure of this information by companies suggests that increasing numbers of companies believe that the market finds the disclosure useful.¹³⁵ Further, there is a line of academic research suggesting that there is an association between auditor tenure and increases or decreases in audit quality.¹³⁶

Although investors may be able to determine auditor tenure by, for example, reviewing past auditor's reports, for many companies the information is not readily available even through a manual search process.¹³⁷ Furthermore, while some companies voluntarily provide information about auditor tenure in the proxy statement, many do not. Many companies are also not subject to the proxy rules (for example, most 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. The Board believes that these issues create unnecessary search costs for investors who wish to evaluate information about auditor tenure. Mandatory disclosure of auditor tenure in the auditor's report will provide a consistent location for this information and will reduce search costs relative to the current baseline for investors who are interested in auditor tenure, especially in the case of companies that do not voluntarily provide such information or for which the information is not available through the EDGAR system. Mandatory disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The existing auditor's report also 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

¹³⁵ See Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016). See also Ernst & Young, *Audit Committee Reporting to Shareholders 2016* (Sept. 2016).

¹³⁶ See Section VI.D.2.f for a discussion of academic research regarding auditor tenure.

¹³⁷ *Supra* note 76.

ways in which investor perceptions of the role and responsibilities of the auditor may diverge from what current professional standards require.¹³⁸ 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, which may increase the time and costs of processing the information in the auditor's report. The final standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.

Commenters generally supported the repropoed changes to these basic elements of the auditor's report. Some commenters noted that the enhanced descriptions of the auditor's responsibility to detect material misstatements would clarify the auditor's responsibilities for financial statement users, other commenters offered suggestions for refinement, such as aligning the requirements to the IAASB model or amending the description to more clearly define the auditor's role within the context of the financial reporting regulatory framework.

Commenters also generally supported including a statement on the auditor's independence requirement. For example, some commenters stated that adding a statement by the auditor on their independence would reinforce investors' understanding of the auditor's requirement to remain independent and objective in expressing the audit opinion. Other commenters said that the enhanced description of the independence requirement could provide a meaningful reminder of the importance of auditor independence. However, other commenters said that the enhanced description of auditor independence was either unnecessary, or would not have a significant impact on auditor behavior. Based on broad commenter support, the Board is adopting these additional improvements to the auditor's report as repropoed.

B. Baseline

1. Critical Audit Matters

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

¹³⁸ 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, 69-90 (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 Bédard, 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).

identifies the company's financial statements that were audited, provides a standardized 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 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.¹³⁹ 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.¹⁴⁰

Academic research confirms the view of the Board and many commenters that the current form of the auditor's report conveys little of the audit-specific information obtained and evaluated by the auditor.¹⁴¹ 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.¹⁴² These findings align with the

¹³⁹ 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.

¹⁴⁰ See paragraph .10 of AI 20, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710*.

¹⁴¹ See Church et al., *The Auditor's Reporting Model: A Literature Overview and Research Synthesis* 69-90.

¹⁴² See Gray et al., *Perceptions and Misperceptions Regarding the*

consistent call from investors, over the course of the Board's rulemaking process, for a more informative auditor's report.¹⁴³

2. *Additional Improvements to the Auditor's Report*

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.¹⁴⁴ 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.¹⁴⁵

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. 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, many larger companies have begun voluntarily disclosing auditor tenure in the proxy statement.

Currently, the title of the auditor's report, "Report of Independent Registered Public Accounting Firm," provides the only indication of the auditor's independence.

Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors 659–684; Mock et al., *The Audit Reporting Model: Current Research Synthesis and Implications* 323–351.

¹⁴³ Academic research has found that, in some instances, the inclusion of explanatory language in the auditor's report may provide investors with additional value-relevant 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. 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. 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).

¹⁴⁴ See existing AS 3101.09.

¹⁴⁵ 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.

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 will 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. Some commenters on the reproposal agreed that the information provided in critical audit matters would be used by various types of investors in a number of different ways that are consistent with the framework outlined in the reproposal:

- *Informing*—Identification of the matters arising from the audit that the auditor considered especially challenging, subjective, or complex, together with a description of how the auditor addressed those matters, which should provide valuable information. For example, some commenters said that:
 - Critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies and make investment decisions;
 - Investors would use critical audit matters in the same way that they use any other financial disclosure; critical audit matters would add an additional perspective to management's disclosures;
 - Insights on critical audit matters may be relevant in analyzing and pricing risks in capital valuation and allocation;
 - Critical audit matters would inform investor models of company financial performance;
 - Critical audit matters would augment and add more dimension to the information provided by the financial statements and the critical accounting policies and estimates; and

- The communication of critical audit matters would lower the cost of acquiring information for financial statement users.
- *Framing*—Critical audit matters should provide investors with a new perspective on the financial statements and focus their attention on the related financial statement accounts and disclosures, which should facilitate their analysis of the financial statements, and help them assess financial performance, for example by highlighting potentially relevant information or by reducing the costs to process or search for the information. For example, some commenters said that:
 - Critical audit matters would focus investors' attention on key financial reporting issues and identify areas that deserve more attention;
 - In jurisdictions where expanded auditor reporting is available, it focuses users' attention on issues that would be pertinent to understanding a company as a long-term investor; and
 - Information in critical audit matters would contribute to investor understanding and consumption of information in the financial statements.
- *Monitoring*—The ability to identify and evaluate the matters identified as critical audit matters should also help investors and analysts engage management with targeted questions about these issues and support investor decisions on ratification of the auditor. For example, some commenters said that:
 - Critical audit matters would facilitate the ability of investors to monitor management's and the board of director's stewardship of the company by highlighting accounting and auditing issues and other matters that investors may wish to emphasize in their engagement with management; and
 - Critical audit matters would provide important information on how the auditor has addressed an issue, which investors can use in evaluating the rigor of the audit and making proxy voting decisions, including ratification of the audit committee's choice of external auditor.

Critical audit matters may be used by different types of investors in different ways. For example, retail investors (or others who may act on their behalf, such as analysts, credit rating agencies, or the financial press) may use the additional

information to help them identify and analyze important aspects of the financial statements. Larger investors, on the other hand, may also use critical audit matters as a basis for engagement with management.

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. 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 the financial performance, highlighting these differences should contribute to the overall mix of information. Further, some commenters on the proposal 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.¹⁴⁶ The Board has been monitoring this research with a view towards assessing its potential relevance to this rulemaking. The Board is mindful 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 final standard 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

¹⁴⁶ 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?* 30 *Accounting Horizons* 255, 255-275 (2016).

experimental setting. In addition, some of these studies were conducted based on earlier versions of rule text that differs from the final standard, which may affect the extent to which the results can inform the Board in evaluating potential effects of the final standard.

As discussed in more detail in the economic analysis contained in the reproposal, the results from early research analyzing the informational value of expanded auditor reporting are inconclusive.¹⁴⁷ Some studies found that expanded auditor reporting could provide investors with new and useful information, while other studies found that the benefits attributable to expanded auditor reporting were not statistically significant, but that it could produce unintended consequences. These limited findings may be due to the fact that the results of the studies represent averages for large samples of companies. On average, investors may already have access to a variety of information sources (such as annual reports, news media, and analyst research reports) which may contain similar information about a company. However, expanded auditor reporting may be relatively more informative for companies where alternative sources of information are less available (e.g., those companies with less analyst coverage).

In response to the reproposal, two commenters submitted studies suggesting that expanded auditor reporting has increased the informative value of the auditor's report. One experimental study tested the communicative value of expanded auditor reporting by analyzing how key audit matters affected investment professionals' assessment of a company's business economics, as well as their confidence in making that assessment.¹⁴⁸ The authors found that specific informational content of the key audit matter affected the study participants' perceived level of trust associated with the auditor's report, which then affected the perceived level of trust associated with the financial statements and their assessment of the company's business economics. Another study analyzed whether the communicative value of auditor's reports changed following the implementation of expanded auditor reporting in the United Kingdom.¹⁴⁹ The author found that the readability of auditor's reports increased in the post-implementation period, and that the use of negative and uncertain words in expanded

¹⁴⁷ See PCAOB Release No. 2016-003, Section VI.C.1.a.

¹⁴⁸ See Annette Koehler, Nicole Ratzinger-Sakel, and Jochen Theis, *Does the Reporting of Key Audit Matters Affect the Auditor's Report's Communicative Value? Experimental Evidence from Investment Professionals* (working paper submitted as comment letter No. 18, available on the Board's website in Docket 034).

¹⁴⁹ See Kecia Williams Smith, *Tell Me More: A Content Analysis of Expanded Auditor Reporting in the United Kingdom* (working paper submitted as comment letter No. 71, available on the Board's website in Docket 034).

auditor's reports captured more client-specific audit risk.¹⁵⁰ In addition, the author found limited evidence that the dispersion of analysts' EPS forecasts decreased following the implementation of expanded auditor reporting, suggesting an improved information environment. The author argued that expanded auditor reporting was successful at increasing the communicative value of the auditor's report, and that analyst behavior changed accordingly. In contrast, another recent experimental study found that including critical audit matters reduced the readability of the auditor's report but did not incrementally inform nonprofessional investors' valuation judgments. However, the study suggested that the reporting of a critical audit matter lowers nonprofessional investors' perceptions of management's credibility when earnings just meet analysts' expectations. The study was designed and implemented using the definition of critical audit matters and related reporting requirements from the Board's proposal, which differ from the final standard.¹⁵¹

In addition, in reviewing the experience of expanded auditor reporting in the United Kingdom, the FRC observed that investors greatly value the information provided in expanded auditor reporting.¹⁵² This view is confirmed by UK investors that commented on the reproposal. The FRC noted that, in the two years following the implementation of the new 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.¹⁵³ 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 that are specific to the entity being audited. Further, the FRC report noted that, in the second year of implementation, a much greater proportion of risks were set out in a more meaningful and transparent way.¹⁵⁴ As noted above, the FRC's requirements for expanded auditor reporting are different from the final standard, and

¹⁵⁰ The author uses several measures designed to assess the readability of texts which, the study notes, have been used in several other published academic studies addressing the readability of financial disclosure. See *id.* at 5.

¹⁵¹ See Brian Carver and Brad Trinkle, *Nonprofessional Investors' Reactions to the PCAOB's Proposed Changes to the Standard Audit Report* (March 2017) (working paper, available in Social Science Research Network).

¹⁵² See FRC 2016 Report.

¹⁵³ See FRC, *March 2015—Extended Auditor's Reports, A Review of Experience in the First Year*, and FRC 2016 Report.

¹⁵⁴ *Id.*

the baseline legal and regulatory environment is not the same as in the United States. Nevertheless, the Board believes that there are sufficient similarities for the UK experience to be generally informative in its decision-making.

While it is too early for the body of academic research on expanded auditor reporting to provide a conclusive answer, investors commenting during the Board's standard-setting process have consistently affirmed the usefulness of expanded auditor reporting and the FRC's observations on the early experience of investors in the United Kingdom are consistent with this view. Accordingly, the Board believes that auditor communication of critical audit matters will add to the mix of information that investors can use.

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.¹⁵⁵ This type of problem is the result of the inability of the principal to observe or monitor the agent's behavior, which also inhibits the principal's ability to identify and reward optimal behavior, or punish sub-optimal behavior. Economic theory posits that the disclosure of information can have indirect effects that lead to changes in behavior.¹⁵⁶ In the context of expanded auditor reporting, the additional information provided in the auditor's report could be beneficial to investors by providing more information about the audit, which could affect their voting decisions. To the extent that this could influence the terms of the auditor's engagement, academic research suggests "any additional information about the agent's action, however imperfect, can be used to improve the welfare of both the principal and the agent."¹⁵⁷

¹⁵⁵ 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).

¹⁵⁶ See, e.g., George Loewenstein, Cass R. Sunstein, and Russell Golman, *Disclosure: Psychology Changes Everything*, 6 *Annual Review of Economics* 391, 391-419 (2014).

¹⁵⁷ See Holmstrom, *Moral Hazard and Observability* at 75.

This suggests that making aspects of the audit more visible to investors through the communication of critical audit matters should provide some auditors, management, and audit committees with additional incentives to change their behavior in ways that may enhance audit quality and ultimately financial reporting quality. For instance, the communication of critical audit matters could lead:

- Auditors to focus more closely on the matters identified as critical audit matters;
- Audit committees to focus more closely on the matters identified as critical audit matters and to engage the auditor and management about the adequacy of the related disclosures; and
- Management to improve the quality of their disclosures because they know that investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters.

The communication of critical audit matters could 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 could further incentivize auditors to demonstrate the level of professional skepticism necessary for high quality audits in the areas of the critical audit matters. Other commenters stated that the reporting of critical audit matters could result in increased audit quality. For example, auditors could 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 could also heighten management's attention to the relevant areas of financial statements and related disclosures. Several commenters stated that the reporting of critical audit matters would lead management to improve the quality of their disclosures or adopt more widely accepted financial reporting approaches in these areas.¹⁵⁸

¹⁵⁸ To substantiate this point, one commenter cited a memo prepared for the clients of an international law firm that noted management should consider revising or supplementing their own disclosures relating to issues raised in expanded auditor's reports to ensure that the totality of disclosures around the issue are complete and accurate. See Sullivan & Cromwell LLP, *Audit Reports, PCAOB Releases Reproposal of Amendments to Its Audit Report Standard* (May 25, 2016).

An experimental study analyzed the joint effect of expanded auditor reporting and audit committee oversight on management disclosure choices.¹⁵⁹ The author found that the study participants, who were currently serving as public company financial executives, chose to provide the greatest level of disclosure when they knew that the auditor's report would provide a more detailed description of the accounting estimate, and the audit committee exhibited strong oversight. The author argued that, similar to what other academic research has found regarding the resolution of audit adjustments, information presented in critical audit matters would be the outcome of a negotiation process between the auditor and management.

Increased management attention to the related aspects of the financial statement accounts and disclosures described in the critical audit matters should, at least in some cases, lead to an incremental increase in the quality of the information presented. Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.¹⁶⁰

In addition, the communication of critical audit matters may enhance the audit committee's oversight efforts by providing an additional incentive for the audit committee to engage with the auditor and management about the matters identified as critical audit matters and the adequacy of the company's related disclosures. Although some commenters stated that the required communication of critical audit matters would "chill" communications between the auditor and the audit committee, others said that it would enhance communications between these parties. Further, it should be noted that the final standard does not change the Board's existing requirements on audit committee communications, other than requiring the auditor to provide the audit committee with a draft of the auditor's report.

To the extent changes in the behavior of auditors, audit committees, and management occur, they could lead to an incremental increase in audit quality and financial reporting quality, which should 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 audit and the audited

¹⁵⁹ See Stephen H. Fuller, *The Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Management Financial Disclosure Decisions* (working paper submitted as comment letter No. 49, available on the Board's website in Docket 034).

¹⁶⁰ 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.

financial statements. Academic research suggests that an increase in investor confidence should decrease the average cost of capital.¹⁶¹ As discussed in the economic analysis of the reproposal, some empirical studies conducted in other jurisdictions provide evidence that expanded auditor reporting increased audit quality, while other studies found that it did not have a measurable effect on audit quality.¹⁶² The Board is not aware of any empirical studies indicating that expanded auditor reporting had a negative effect on audit quality.

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 should serve as a potential means of greater differentiation among accounting firms and engagement partners.¹⁶³ One commenter stated that the reporting of critical audit matters would allow auditors to differentiate themselves, and that this differentiation would provide useful information to investors and other financial statement users. If expanded auditor reporting allows investors to differentiate among accounting firms and engagement partners, it should provide a more nuanced signal of audit quality and financial reporting reliability.

The FRC report also noted that there are clear differences among accounting firms in the approaches taken to implement the requirements.¹⁶⁴ 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

¹⁶¹ 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, now known as the Office of Economic and Risk Analysis. The research cited here was published before he joined the PCAOB.

¹⁶² See PCAOB Release No. 2016-003, Section VI.C.1.b, footnotes 154-156 and accompanying text.

¹⁶³ 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. See PCAOB Release No. 2015-008.

¹⁶⁴ See FRC 2016 report.

suggest that accounting firms took different approaches to expanded auditor reporting as a means of distinguishing themselves based on the quality and usefulness of the information provided in their auditor's reports. Furthermore, as discussed in the economic analysis of the reproposal, an academic study argued that investors found the auditor's reports issued by some accounting firms to be more useful than others.¹⁶⁵ One commenter specifically noted that mandatory auditor rotation was introduced in the UK at the same time as expanded auditor reporting, and that this may have provided accounting firms with motivation to differentiate themselves.

In addition to relying on the audit committee (which, at least for exchange-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.¹⁶⁶

The identification and description of critical audit matters should 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 and communication 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 more detailed description of critical audit matters may not necessarily reflect a higher quality audit than a less informative description of such matters.

Nevertheless, informative descriptions of how the audit addressed critical audit matters should 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

¹⁶⁵ See PCAOB Release No. 2016-003, Section VI.C.1.b, footnote 161 and accompanying text.

¹⁶⁶ See, e.g., Jere 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).

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 that participated in the audit,¹⁶⁷ and other relevant information should enable differentiation among engagement partners and accounting firms on that basis.

2. *Additional Improvements to the Auditor's Report*

The final standard will introduce new requirements regarding auditor tenure, the addressee of the auditor's report, and statements in the auditor's report related to auditor independence and the auditor's responsibility for reporting on ICFR.¹⁶⁸ In addition, the final standard contains other changes to the form of the auditor's report, which are 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 to promote a consistent presentation of this information across auditor's reports.

Investor commenters have consistently supported disclosing tenure in the auditor's report. In the Board's view, which is consistent with the views of some commenters,¹⁶⁹ disclosing information about auditor tenure in the auditor's report will provide a consistent location for this information and decrease the search costs, relative to the current environment of voluntary reporting, for some investors and other financial statement users who are interested in this information.

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 will be promoting uniformity in the addressees of the auditor's report.

Commenters were generally supportive of the repropoed changes to the form of the auditor's report. For example, some commenters stated these enhancements would

¹⁶⁷ See PCAOB Release No. 2015-008.

¹⁶⁸ In circumstances where management is required to report on ICFR but the auditor is not and has not performed an audit of ICFR, the final standard requires a statement to that effect in the auditor's report.

¹⁶⁹ See *also* Section VI.D.2.f for a discussion of academic research regarding auditor tenure.

make the auditor's report easier to read and would facilitate comparisons between auditor's reports for different companies by providing a consistent format.

D. Costs and Potential Unintended Consequences

1. Costs

Commenters on the reproposal raised concerns that the rule would impose various types of costs, but generally did not quantify those costs. Even those that, at an earlier stage of the rulemaking, conducted limited implementation testing of the proposal were unable to provide a quantified cost estimate. Given 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 final standard, PCAOB staff has reviewed data from the first year of implementation of expanded auditor reporting in the United Kingdom.¹⁷⁰ 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 final standard, 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

The Board anticipates that the final requirements regarding critical audit matters will have potential cost implications for auditors and companies, including their audit committees. Such costs will likely relate to additional time to prepare and review auditor's reports, including discussions with management and audit committees, as well as legal costs for review of the information provided in the critical audit matters. In addition, auditors may choose to perform more audit procedures related to areas reported as critical audit matters (even though performance requirements have not changed in those areas), with cost implications for both auditors and companies.

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

¹⁷⁰ See PCAOB, *White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700* ("PCAOB White Paper") (May 2016), available on the Board's website in Docket 034.

quality control methodologies to reflect the new reporting requirements; and (2) developing and conducting training of accounting firm personnel on the new reporting requirements. When updating methodologies, some accounting firms will likely also develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters. One commenter suggested that the initial implementation costs could place a significant and possibly disproportionate burden on smaller accounting firms.

Recurring costs will primarily reflect additional effort expended in individual audits. The final standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which will be based on work the auditor has already performed. However, there will 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, will 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, will 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, will likely also incur both one-time and recurring costs as a result of the final 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 will 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 will 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 may also be in the process of finalizing 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 likely involve senior management that command relatively high annual salaries or experienced auditors and lawyers with relatively high hourly billing rates. In addition, the communication of critical audit matters could lead to changes in management's disclosures, which may result in more effort and cost in the financial reporting process.

Several commenters on the reproposal claimed that the required reporting of critical audit matters would lead to increased audit fees, but none provided data or estimates regarding the magnitude of the increases they expected. Commenters on the proposal had differing views 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 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.

One commenter argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. Some commenters noted that investors would be expected to ultimately bear the cost of the audit, and these commenters have voiced strong support for expanded auditor reporting since the project's inception. This suggests that they consider the benefits of expanded auditor reporting to justify the costs, and would support additional fees for additional useful information.

Audit fees do not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms choose 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. Subject to those limitations, 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.¹⁷¹ For 53 percent of the companies analyzed, 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, roughly consistent with the findings of academic research described in the economic analysis in the reproposal. However, the staff found that the median change in audit fees was zero. Collectively, these results seem to suggest that outlier companies with relatively large increases in audit fees drove the result for the average change in audit fees. It should be noted that the PCAOB staff's review did not analyze whether other factors, such as inflation, changes in the economic environment and corporate risk, corporate acquisitions, or the implementation of other regulatory changes, contributed to the documented increase in audit fees.

One commenter on the reproposal noted that the caveats described above are important because the inability to fully gauge the costs of expanded auditor reporting could lead the Board to underestimate the costs associated with the rule, which may

¹⁷¹ *Id.*

bear disproportionately on smaller companies and their auditors. Another commenter also asserted that the costs of expanded auditor reporting are likely to be disproportionately borne by smaller companies because the repropose rule had, in their estimation, limited scalability. The Board believes that the complexity and costs associated with determining, documenting, and communicating critical audit matters should generally depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

b. Additional Improvements to the Auditor's Report

The changes adopted to the basic elements of the auditor's report do not represent a significant departure from the reproposal. Some of the enhanced basic elements will have cost implications for auditors, although these costs are not expected to be significant. One-time costs will 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 changes adopted to the basic elements will impose significant recurring costs, because the year in which tenure began will not change and the other amendments involve standardized language that, once implemented, will 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. On this point, the PCAOB staff study did not find evidence that compliance with the United Kingdom's 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. Further, academic research cited in the economic analysis of the reproposal similarly did not find that the UK reporting requirements led to delays in financial reporting.¹⁷²

¹⁷² See PCAOB Release No. 2016-003, section VI.D.2.a, footnote 169 and accompanying text.

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 or that auditors would have incentives to communicate an overly long list of critical audit matters. For example, some commenters 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, or as a means to avoid potential consequences of being second-guessed by regulators or others. Other commenters asserted that such a development could make the auditor's report overly long, contributing to disclosure overload and conflicting with the SEC's disclosure effectiveness project. Other commenters indicated that expanded auditor reporting could lead to boilerplate language that would diminish the expected value of the critical audit matters and obscure the clarity of the auditor's opinion. If auditors fail to provide audit-specific information, the communication of critical audit matters will 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 final 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. Limiting critical audit matters to these areas should mitigate the extent to which expanded auditor reporting could become standardized. Focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. Also, while some commenters argued that liability concerns would increase the number of critical audit matters auditors communicate, others suggested that liability concerns would minimize the additional statements auditors make.

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.¹⁷³ 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 on the first two years of expanded auditor reporting in the United Kingdom finds a similar range and average number of risk topics disclosed in both the first and second year of implementation.¹⁷⁴

¹⁷³ See PCAOB White Paper.

¹⁷⁴ See FRC 2016 Report.

The FRC report also finds disclosure of similar risk topics in the second year of implementation of expanded auditor reporting in the United Kingdom.¹⁷⁵

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 risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.¹⁷⁶ These findings suggest that, thus far, expanded auditor reporting has not become standardized in the United Kingdom.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 requirements. For example, even though the final standard does not mandate the performance of additional audit procedures other than with respect to communication of critical audit matters, it is possible that 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. Some commenters suggested that the increased attention on certain matters could also lead to a related decrease in audit and financial reporting quality if other material aspects of the financial statements and disclosures receive less attention.

Some commenters argued that including critical audit matters in the auditor's report would impair the relationship between auditors and management or auditors and the audit committee. Other commenters suggested that the required reporting of critical audit matters would inhibit communication among the auditor, management, and the audit committee because of concerns about what would be publicly communicated in

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ The Board finds the UK experience instructive, although it is, of course, possible that differences between the UK and US litigation and regulatory environments may influence the extent to which these findings would generalize to the US market.

the auditor's report. One commenter also suggested that auditors may include additional matters in audit committee communications out of concern that an omission could lead to regulatory sanctions or liability. Other commenters have said that it would enhance communication among the participants in the financial reporting process.

An experimental study analyzed how the strength of audit committee oversight of the financial reporting process varied with the presence of sophisticated investors and knowledge of forthcoming expanded auditor reporting.¹⁷⁸ The author found that study participants, most of whom were experienced audit committee members, asked fewer probing questions if they knew that the auditor would be providing a discussion of the significant accounting estimate in the auditor's report. The author argued that by asking fewer probing questions audit committee members subconsciously insulated themselves from potential challenges mounted by investors regarding the appropriateness of the company's financial reporting. The Board is not aware of evidence this has occurred in the jurisdictions that have adopted expanded auditor reporting. Moreover, it may be difficult in an experimental setting to recreate the actual legal responsibility and potential liability that audit committee members face, which may limit the extent to which the experimental results would generalize to actual behavior in real-world settings.

Similarly, as described in the economic analysis of the reproposal and asserted by at least one commenter, management may have an incentive to withhold information from the auditor in order to prevent an issue from being described in the auditor's report. It seems unlikely, however, that management would or could withhold information from the auditor on the most critical issues in the audit because it could result in a scope limitation. On the contrary, it may be just as likely that management would communicate more information to the auditor as a means of demonstrating that an issue is not challenging, subjective, or complex, and, therefore, would not need to be described in the auditor's report.

Under the final standard, critical audit matters are determined from the matters communicated or required to be communicated to the audit committee. As noted earlier, with respect to any matters already required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. Therefore, 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

¹⁷⁸ Yoon Ju Kang, *Are Audit Committees More Challenging Given a Sophisticated Investor Base? Does the Answer Change Given Anticipation of Additional Mandatory Audit Report Disclosure?* (working paper submitted as comment letter No. 17, available on the Board's website in Docket 034).

previously described, given the breadth of current communication requirements, the Board believes there will likely be few communications affected by that possibility.

d. Potential Impact on Management Disclosure

Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management. While some commenters asserted that this would be beneficial, others claimed it would be an unintended negative consequence of requiring the communication of critical audit matters. Several commenters characterized this as inappropriately expanding the role of the auditor in the financial reporting process, while undermining the role of management and the audit committee. In their view, this would be especially problematic if the final standard permitted the auditor to communicate information that was not otherwise required to be disclosed (for example, because it did not meet a specified threshold for disclosure, such as a significant deficiency in internal control over financial reporting). Commenters claimed that auditor communication of this "original information" would cause a number of unintended consequences, including significant costs, disclosure of confidential or competitively sensitive information, and potentially misleading or incomplete information.¹⁷⁹

Investors and other commenters pointed out that, although expanded auditor reporting would give the auditor additional leverage over management's disclosure choices, this could result in improvements in the usability of financial statements and increases in financial reporting quality. One of these commenters cited academic research noting that, in current practice, disclosure is already guided by an iterative process between management and the auditor. This commenter reasoned that concerns regarding "original information" were misplaced because the iterative process would reduce the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.

Another commenter pointed out that auditors would not have incentives to interpret the Board's rule to require disclosure of original information in most situations. For example, concerns about the limitations of their knowledge and expertise, potential liability implications, and friction in the relationship with the company are likely to discourage auditors from going beyond management disclosures. Nevertheless, the final standard contemplates that the auditor will do so only when it is necessary to describe the principal considerations that led the auditor to determine that a matter was especially challenging, subjective, or complex and how the matter was addressed in the audit. The Board believes that this provision is needed in order to ensure that the fact

¹⁷⁹ For a complete discussion of these concerns, see Section IV.A.2.c.i.

that management did not provide a disclosure would not prevent the auditor from communicating a critical audit matter.

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 from the Board's outreach activities suggests that the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications.

e. 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 auditor on matters identified as critical audit matters, including that it could undermine the basic pass/fail opinion. This could lead investors to erroneously conclude that there is a problem with the audit either in the areas identified in critical audit matters or other areas, or that auditors are providing separate assurance about the presentation of the financial statements, which may have implications for perceptions of auditor responsibility in the event of an audit failure.

As discussed in the economic analysis of the reproposal, several academic papers analyze certain risks associated with communicating critical audit matters, including perception of auditor responsibility.¹⁸⁰ If the communication of critical audit matters were to lead to a reduction in perceived auditor responsibility, as is suggested by some academic research, 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, which could adversely affect audit quality (although the Board's other auditing standards, reinforced through firm quality control and Board inspections and enforcement activity, should provide a disincentive for auditors to decrease the amount or quality of audit work performed). It is difficult to draw generalizable conclusions based on the findings of these studies. In part, this is because their results vary and are

¹⁸⁰ See PCAOB Release No. 2016-003, Section VI.D.2.d, footnotes 182-186 and accompanying text.

sometimes contradictory, with some studies finding that expanded auditor reporting increases perceived auditor responsibility and others finding that it decreases perceived auditor responsibility. This may suggest that the results are sensitive to the experimental design and the context in which information is presented to study participants. In addition, it is not clear how the findings would correlate with changes in auditor behavior, because perceptions of auditor responsibility may be a poor proxy for actual auditor responsibility or liability.

To address the risk that the communication of critical audit matters could result in the perception of separate assurance, the final standard requires the following statement in the auditor's report:

The communication of critical audit matters does not alter in any way [the auditor's] opinion on the financial statements, taken as a whole, and [the auditor is not] by communicating the critical audit matters... providing 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. In this regard, the Board also notes the view of some commenters that critical audit matters are likely to be used by institutional investors that are unlikely to misinterpret the information.

f. Auditor Tenure

Many commenters stated that information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about correlations between auditor tenure and/or independence and audit quality. Academic research on the relationship of tenure to audit quality has varied conclusions. For instance, 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.¹⁸¹ 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

¹⁸¹ 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).

quality.¹⁸² Still 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.¹⁸³

The disclosure of auditor tenure is intended to add to the mix of information that investors can use. However, commenters other than investors did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors or could result in false conclusions about correlations between auditor tenure and audit quality or between auditor tenure and auditor independence. Many of these commenters recommended that, if the Board determined to require disclosure of auditor tenure, it should be disclosed in Form AP rather than in the auditor's report as a means of avoiding these inferences.

E. Alternatives Considered, Including Policy Choices under the Final Standard

After considering the comments received, the Board is adopting a new auditor reporting standard, AS 3101 and related amendments to its standards. The final standard retains the pass/fail model while expanding auditor reporting to include the communication of critical audit matters. Investor commenters have consistently asked for additional information in the auditor's report to make it more informative about the audit of the company's financial statements.

As described below, the Board has considered a number of alternative approaches to achieve the potential benefits of enhanced auditor reporting.

1. Alternatives Raised by Commenters

a. Only Cross-Reference to Management's Disclosures

Some commenters suggested that, instead of communicating critical audit matters as repropounded, auditors should only identify the critical audit matters and provide a cross-reference to management disclosures (i.e., not describe the principal considerations that led the auditor to determine a matter is a critical audit matter or how

¹⁸² 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).

¹⁸³ 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).

it was addressed in the audit), or refer to or list critical accounting policies and estimates as disclosed by management. The Board believes that communicating the principal considerations that led the auditor to determine that a matter is a critical audit matter and how it was addressed in the audit will provide useful information beyond simply referencing existing management disclosure, and is more responsive to investor requests for more information from the auditor's perspective.

b. Auditor Association with Other Company Disclosures

Other commenters suggested more specific auditor assurance on particular management disclosures, such as inclusion of a statement in the auditor's report that the audit included evaluation of the accounting policies and significant estimates, with a cross-reference to management's disclosures, or a statement of auditor concurrence with the critical accounting policies and estimates of the company. One commenter suggested that audit committees should disclose critical audit matters with a corresponding confirmation from the independent auditor.

Several commenters on the proposal also 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.

Some commenters on the concept release, including investors, said that they were 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 complexity of such an approach, as well as the comments received as to its limited benefits, the Board determined not to pursue auditor association with portions of MD&A as an alternative to expanded auditor reporting at this time. The Board believes that this approach would fail to deliver the audit-specific information requested by investors, while also raising potential concerns about separate assurance on the identified matters.

c. 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.

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

In developing the final standard, 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. Several commenters suggested that the Board align its requirements for expanded auditor reporting more closely with the requirements of the IAASB to 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 considers 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 identical to 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, which could result in differences in which matters are reported even if the language in the auditor reporting standards were identical. Also, the component of the definition of critical audit matter in the final standard, namely "matters that involve especially challenging, subjective, or complex auditor judgment" grounds the definition in the auditor's expertise and judgment.

Although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria 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.

e. Auditor Assessment and Descriptions of Certain Financial Statement Areas

Several commenters on the concept release 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; (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.¹⁸⁴ This request was reiterated by several commenters on the proposal, who continued to believe that this approach would provide the information investors want most. In a similar vein, other commenters on the reproposal have requested that the auditor provide a "grade" on management's significant accounting estimates and judgments.

The Board believes that the final critical audit matter definition will 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 will 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.

The final standard 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") may 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

¹⁸⁴ See IAG 2011 survey.

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 may subject auditors and companies 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 Board's considerations.

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.

c. Auditor Tenure

The final standard retains the repropoed requirement to include a statement in the auditor's report about auditor tenure.

In the reproposal, the Board solicited comment on whether disclosure of auditor tenure should be made on Form AP instead of in the auditor's report. Form AP was developed as a means to address commenter concerns about the potential liability implications of naming persons in the auditor's report. Because the disclosure of auditor tenure does not have the same potential liability consequences, such an approach is unnecessary in this case. In addition, some commenters preferred tenure disclosure on Form AP because of a concern that disclosure in the auditor's report could result in inappropriate inferences about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. The Board is not persuaded by such concerns. Further, the final standard allows the auditor flexibility in the location of the auditor tenure disclosure in the auditor's report.

The Board determined that disclosure will be better achieved through the auditor's report because the information will be more readily accessible upon the filing with the SEC of a document containing audited financial statements and poses lower search costs, particularly for those investors who may prefer to have the information provided in the auditor's primary means of communication. In addition, disclosing tenure in the auditor's report will make information available earlier to investors, which may assist in their voting on auditor ratification. However, disclosing auditor tenure in the

auditor's report rather than Form AP could result in higher costs to investors that wish to accumulate tenure data for a large number of companies or compare data across companies because these investors will have to acquire tenure data from each company's auditor's report separately or from a data aggregator.

See *also* Section IV.B.1 for a discussion of the Board's considerations.

d. Additional Improvements to the Auditor's Report

The final standard includes a number of requirements that will 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 final standard 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.

Many commenters generally supported these enhancements and suggested that such enhancements will 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.

VII. Applicability of Critical Audit Matter Requirements

A. Brokers and Dealers, Investment Companies, and Benefit Plans

The repropose standard did not require communication of critical audit matters for audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than business development companies ("BDCs"), and benefit plans. The repropose release described the Board's rationale, including economic considerations, for such exclusions from the critical audit matter requirements and noted that auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

Commenters generally supported these exclusions, pointing to the same or similar reasons to those described by the Board in the repropose release. Some commenters asserted that the communication of critical audit matters should apply to all companies. One commenter supported voluntary communication of critical audit matters for the exempted entities. Another commenter disagreed with providing auditors the ability to voluntarily communicate critical audit matters for brokers and dealers and

investment companies. This commenter also suggested that all broker-dealers, including broker-dealers that are issuers, should be excluded from the requirement.

After considering the comments received and evaluating benefits and costs, the final standard excludes the audits of brokers and dealers that are reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans, from the critical audit matter requirements as repropoed.¹⁸⁵ Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily.

The Board's rationales for these exclusions are described below.

1. *Brokers and Dealers Reporting under Exchange Act Rule 17a-5*

Pursuant to Exchange Act Rule 17a-5, the annual reports that brokers and dealers file with the SEC 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.¹⁸⁶ 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.¹⁸⁷ Research by the PCAOB's Office of Economic and Risk Analysis ("ERA")¹⁸⁸ 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.

In 2013, the Board adopted new standards related to brokers and dealers that enhanced the auditor's performance and reporting responsibilities for financial

¹⁸⁵ The other requirements of the final standard will be applicable to audits of these entities.

¹⁸⁶ See Exchange Act Rule 17a-5(e), 17 CFR 240.17a-5(e).

¹⁸⁷ 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.

¹⁸⁸ ERA'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.

statement audits, as well as engagements on compliance and exemption reports of brokers and dealers.¹⁸⁹

Some commenters on the proposal asserted that the value of reporting critical audit matters for brokers and dealers would be significantly limited by the closely held nature of brokers and dealers; the limited number of users of their financial statements; and 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.

Research by ERA indicates that currently there are no brokers or dealers that are issuers. Rather, brokers and dealers are often owned by a holding company, an individual, or a group of individuals 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, in many cases, there is much less separation of ownership and control in brokers and dealers than in issuers, the communication of critical audit matters would provide little information about the audit that would otherwise be unobtainable by investors.

Although there may be circumstances in which other financial statement users may benefit from reduced information asymmetry about the audits of brokers and dealers, 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 file certain financial statements and schedules confidentially would require the auditor to identify and communicate critical audit matters that apply only to the publicly available statement of financial condition. This may reduce the value of communicating critical audit matters for brokers and dealers relative to issuers. Moreover, customers of brokers and dealers may be interested in the overall financial position of the broker or dealer but may not benefit from audit-specific information in the same way as investors in an issuer.

The communication of critical audit matters may also impose additional costs on the auditors of brokers and dealers relative to the auditors of other types of companies,

¹⁸⁹ 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 No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

as they would have to identify critical audit matters that apply exclusively to the publicly available financial information, which may be difficult in some situations.

After consideration of the ownership and reporting characteristics of brokers and dealers, the comments received on the proposal and reproposal, 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 will provide meaningful information in the same way as for issuers. Therefore, the communication of critical audit matters is not 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.

2. *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.¹⁹⁰ 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.¹⁹¹ 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.¹⁹²

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.¹⁹³ The disclosure of information about these items appears in the annual prospectus that investment companies provide to current and future investors.¹⁹⁴

¹⁹⁰ See Section 3(a)(1) of the Investment Company Act.

¹⁹¹ See SEC Rules under Section 30(e) of the Investment Company Act.

¹⁹² See, e.g., Sections 12, 13, and 17 of the Investment Company Act.

¹⁹³ 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.

¹⁹⁴ See SEC Rules under Section 30(e) of the Investment Company Act.

Changes to investment objectives and strategies require shareholder approval or disclosure.¹⁹⁵

Several commenters on the 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. These and other 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. One of these commenters 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.

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.¹⁹⁶ 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 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.

¹⁹⁵ See Sections 8(b) and 13(a)(3) of the Investment Company Act and Investment Company Act Rule 8b-16.

¹⁹⁶ See, e.g., Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

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 on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of most investment companies, although they will apply to audits of investment companies regulated as BDCs.¹⁹⁷ Unlike the audits of many other investment companies, auditing the valuation of BDCs' investments generally involves 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 is appropriate for audits of BDCs to be subject to critical audit matter requirements.

3. *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-K¹⁹⁸ that includes the benefit plan's audited financial statements and the related auditor's report.¹⁹⁹ 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

¹⁹⁷ See Section 54 of the Investment Company Act.

¹⁹⁸ See Section 15(d) of the Exchange Act.

¹⁹⁹ 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 Exchange Act Rule 15d-21, CFR 240.15d-21.

Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.²⁰⁰

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 on the proposal 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 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.

²⁰⁰ ERISA Section 103(a)(3)(A) requires a plan administrator to engage an independent auditor to conduct an examination of the plan's financial statements and required schedules in accordance with generally accepted auditing standards. See 29 CFR 2520.103-1. 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. See *also* FASB ASC 960-10-05-6.

After consideration of the structure and reporting characteristics of benefit plans and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of benefit plans.

B. Smaller Companies

The reproposal sought comment on whether the critical audit matter requirements should not apply to audits of other types of companies, in addition to the exempted entities discussed above. Some commenters asserted that the communication of critical audit matters should apply to all companies. Other commenters recommended that the Board give consideration to not applying the critical audit matter requirements to audits of smaller reporting companies²⁰¹ and nonaccelerated filers²⁰² due to their smaller size and because, in the commenters' view, communication of critical audit matters would not provide sufficient benefits for these companies to justify the costs.

Academic research suggests that smaller companies have a higher degree of information asymmetry relative to the broader population of companies. 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.²⁰³ To the extent that a

²⁰¹ In general, a "smaller reporting company" means an issuer with less than \$75 million in public float or zero public float and annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. See Exchange Act Rule 12b-2, 17 CFR 240.12b-2. Smaller reporting companies currently make up approximately 42 percent of Form 10-K filers. The SEC recently proposed changes to the definition of smaller reporting companies, which would increase the percentage of smaller reporting companies to approximately 52 percent of Form 10-K filers. See SEC, *Amendments to Smaller Reporting Company Definition*, Release No. 33-10107 (June 27, 2016), 81 FR 43130 (July 1, 2016).

²⁰² Nonaccelerated filers are not defined in SEC rules but are generally understood to be companies that do not meet the definition of large accelerated filer or accelerated filer.

²⁰³ See, e.g., David Aboody, and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 *The Journal of Finance* 2747, 2747-2766 (2000), Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361, 361-381 (1995), Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics*

smaller company can be characterized as exhibiting one or more of these properties, this may suggest that it has a greater degree of information asymmetry relative to the broader population of companies. This would suggest that there is a higher likelihood that critical audit matters could provide new information about a smaller company than a large one for which there already exists a variety of information sources (such as annual reports, news media, and analyst research reports).

After consideration of comments, academic research, and data regarding the number of such companies, the final standard does not exclude smaller companies from the critical audit matter requirements. However, as discussed below, the Board has determined that it is appropriate to give auditors of smaller companies additional time to implement the new requirements. If approved by the SEC, auditors of companies that are not large accelerated filers will have an additional 18 months to implement the requirements for critical audit matters and will be able to benefit from the experiences of auditors of larger companies.

Requirements of Other Regulators and Standard Setters

Under the IAASB's standard, the communication of key audit matters applies to listed entities.²⁰⁴ The EU requirements apply to audits of PIEs, including listed companies, credit institutions, and insurance companies.²⁰⁵ The FRC 2013 requirements apply to auditor's reports for entities that apply the UK Corporate Governance Code.²⁰⁶

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 EGCs, as defined in Section 3(a)(80) of the Exchange Act. Section 104 provides that "[a]ny

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).

²⁰⁴ See paragraph 5 of ISA 701.

²⁰⁵ See requirements in 1 of Article 2, *Audit Report* of Regulation (EU) No 537/2014.

²⁰⁶ 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.

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 . . ."²⁰⁷ Auditor discussion and analysis ("AD&A") does not exist in auditing standards. The idea was introduced in the concept release, which described AD&A as one of several conceptual alternatives for changing the auditor's reporting model.²⁰⁸

Section 104 of the JOBS Act further provides that any additional 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."²⁰⁹ As a result of the JOBS Act, the final standard and amendments are subject to an evaluation as to whether they could, and if so, should be applicable to the audits of EGCs.

A. Critical Audit Matters

The reproposal solicited comment on the application of critical audit matter requirements to the audits of EGCs. Commenters on this issue generally favored applying the standard to audits of EGCs, primarily because investors in these companies would benefit from the additional information communicated in the auditor's report in the same way that investors in larger companies would. Two commenters recommended that the critical audit matter requirements not apply to audits of EGCs because there would not be sufficient benefits to justify the costs.

Three commenters addressed the legal question of whether the JOBS Act provision on AD&A would prohibit the Board from applying critical audit matter requirements to audits of EGCs. Two of these commenters suggested that this would be

²⁰⁷ See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act.

²⁰⁸ See PCAOB Release No. 2011-003 (June 21, 2011) at 2 (describing one alternative as "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements (an 'Auditor's Discussion and Analysis')"). Section IV.A., *Auditor's Discussion and Analysis*, of the proposal further described AD&A and related comments received on the concept release.

²⁰⁹ *Supra* note 207.

prohibited, on the basis that critical audit matters "appear substantively similar to"²¹⁰ or "closely resemble"²¹¹ AD&A. The SEC's Investor Advocate stated that, from a policy perspective, critical audit matter requirements should apply to audits of EGCs, and recommended that the PCAOB adopt the standard for policy reasons and let the SEC determine the legal question.²¹² This commenter also recommended that, "to prepare for any outcome of [the SEC's] determination," the PCAOB should "encourage auditors, on a voluntary basis, to include critical audit matter communications in the auditor's reports on EGCs."²¹³

The requirements for critical audit matters share characteristics with two of the alternative approaches described in the concept release: required and expanded explanatory paragraphs and AD&A. Similar to critical audit matters, required and expanded explanatory paragraphs involved additional paragraphs in the auditor's report that would have highlighted areas of critical importance to the financial statements, with auditor comment on key audit procedures and a reference to relevant financial statement accounts and disclosure. AD&A, by contrast, envisioned a supplemental report in addition to the auditor's report that could cover a broad range of issues, including the auditor's views regarding the company's financial statements, material matters as to which the auditor believed disclosure could be enhanced, and areas where management could have applied different accounting or disclosure approaches.

However, critical audit matters go beyond the content of a required and expanded explanatory paragraph by including a discussion of the principal reasons the auditor determined that a matter was a critical audit matter. Further, although this is not required, critical audit matters could potentially include a discussion of auditor findings. These additional elements may make critical audit matters resemble AD&A in some respects. This potential similarity, together with the fact that there has been no authoritative interpretation of Section 104 of the JOBS Act, creates some uncertainty as

²¹⁰ See letter from the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Aug. 15, 2016) at 10, available on the Board's website in Docket 034.

²¹¹ See letter from Robert N. Waxman (Aug. 15, 2016) at 24, available on the Board's website in Docket 034.

²¹² See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 5-6, available on the Board's website in Docket 034 (noting that "the SEC will need to make a legal determination on whether such a requirement with respect to the audits of EGCs would accord with certain provisions of" the JOBS Act).

²¹³ *Id.* at 6.

to whether it is legally permissible for critical audit matter requirements to be mandated for EGC audits. In view of this uncertainty, the Board has determined not to apply the requirements regarding critical audit matters to audits of EGCs at this time.

As with other audits where critical audit matter requirements do not apply, voluntary application is permissible. EGCs and their auditors can consider whether investors would benefit from additional information about the audit from the auditor's point of view.

B. Additional Improvements to the Auditor's Report

The additional improvements to the auditor's report contained in the final standard and amendments do not raise concerns under the AD&A provisions of the JOBS Act, but instead fall within the category of "additional rules" that may not be applied to audits of EGCs unless the SEC determines that doing so "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." The Board is providing this analysis to assist the SEC in making this determination.

To inform consideration of the application of auditing standards to audits of EGCs, the staff has also published a white paper that provides general information about characteristics of EGCs.²¹⁴ The data on EGCs outlined in the white paper remains generally consistent with the data discussed in the reproposal. 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.²¹⁵

The reproposal solicited comment on whether the elements of the repropose standard and amendments other than the requirements for critical audit matters should apply to the audits of EGCs. As noted above, one commenter supported application of the entire standard and amendments to EGCs (without differentiating between critical audit matters and other elements), and one commenter opposed application of the

²¹⁴ See *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the Board's website in Docket 034.

²¹⁵ 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.

entire standard and amendments. In addition, one commenter supported applying some of the repropoed improvements to the auditor's report to audits of EGCs (the requirement as to addressee and the clarifications of existing auditor responsibilities, as well as a modified version of the statement regarding auditor independence), but generally opposed the other aspects of the repropoal for both EGCs and other companies.

As described in Section VI.C.2. above, the additional improvements to the auditor's report are intended to provide a consistent location and decrease search costs with respect to information about auditor tenure, enhance users' understanding of the auditor's role, make the auditor's report easier to read and facilitate comparison across companies by making the format consistent. As described in Section VI.D.1.b. above, the costs associated with these changes are not expected to be significant and are primarily one-time, rather than recurring, costs.

For the reasons explained above, the Board believes that the additional improvements to the auditor's report contained in the final standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the final standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the SEC determine that it 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, to apply the final standard and amendments, other than the provisions relating to critical audit matters, to audits of EGCs. The Board stands ready to assist the SEC in considering any comments the SEC receives on these matters during the SEC's public comment process.

IX. Effective Date

The repropoal sought comment on how much time auditors would need to implement the standard, if adopted by the Board and approved by the SEC. The repropoal also solicited input on whether the Board should consider a delayed compliance date for the repropoed standard, or for certain parts of the repropoed standard, for audits of smaller companies and, if so, what criteria the Board should use in its consideration.

Commenters suggested a wide range of effective dates for the standard. Some commenters encouraged expeditious adoption of the final standard. One of these commenters suggested an effective date for audits of financial statements for periods ending on or after December 2017. Some commenters recommended that the effective date be a year after approval by the SEC, but no earlier than for auditor's reports issued on or after December 15, 2018. Other commenters suggested that the effective date be no earlier than for audit periods ending two years after approval by the SEC, primarily

because of the audit firms' need to develop and implement training and quality control processes to support expanded auditor reporting. One commenter suggested that the Board delay the effective date until after the implementation of FASB ASU No. 2014-09, *Revenue from Contracts with Customers* (which, for issuers, will apply for fiscal years beginning after December 15, 2017).

Many commenters supported phased implementation of the final standard, or of the portion of the standard related to communication of critical audit matters, suggesting that implementation start with large accelerated filers²¹⁶ and a year later become effective for other companies in order to allow auditors of smaller companies to benefit from the experience of the audits of large accelerated filers.

After considering the comments received, the Board has chosen a phased approach to the effective date for the new requirements. If approved by the SEC, the final standard and related amendments to auditing standards will take effect as follows:

- All paragraphs of the final standard and related amendments, except the paragraphs in the Critical Audit Matters section of the standard (paragraphs .11 through .17) and amendments related to those paragraphs: audits of fiscal years ending on or after December 15, 2017.
- All paragraphs in the Critical Audit Matters section of the final standard and amendments related to those paragraphs:
 - *For audits of large accelerated filers:* fiscal years ending on or after June 30, 2019; and
 - *For audits of all other companies to which the requirements apply:* fiscal years ending on or after December 15, 2020.

A phased approach to the effective date will provide investors and other financial statement users with the new form auditor's report, other than the communication of critical audit matters, as soon as reasonably practicable. The later effective dates for the communication of critical audit matters provide accounting firms, companies, and audit committees more time to prepare for implementation of the requirements that are expected to require more effort to implement than the additional improvements to the auditor's report.

²¹⁶ In general, "large accelerated filer" means an issuer with a public float of \$700 million or more that has been subject to Exchange Act periodic reporting requirements for at least one year and has filed at least one annual report. See Exchange Act Rule 12b-2, 17 CFR 240.12b-2.

In selecting the effective date of the critical audit matter requirements for audits of large accelerated filers, the Board considered commenter suggestions that large accelerated filers and their auditors²¹⁷ generally have more resources to address the new requirements to help establish best practice as compared to smaller companies and their auditors. Further, the Board did not choose a calendar year-end effective date to allow auditors of large accelerated filers to gain experience implementing the critical audit matter communications at a time when fewer audits are being completed, outside of the busy calendar year-end reporting cycle.²¹⁸

In response to comments, the effective date of the final standard with respect to the communication of critical audit matters is delayed by 18 months for audits of companies that are not large accelerated filers. In determining to adopt the effective date for these audits, the Board agreed with commenter input that auditors of smaller companies, which are often smaller audit firms, could benefit from the experience of the audits of large accelerated filers. In addition, the phased effective date may facilitate any post-implementation review of the impact of the final standard.

Auditors may elect to comply before the effective date, at any point after SEC approval of the final standard.

* * *

²¹⁷ Research by ERA indicates that approximately 79 percent of the large accelerated filers that filed audited financial statements with the SEC during the 18 months prior to December 31, 2016 are audited by the four largest US audit firms (measured by number of issuer audits); 6 percent are audited by other annually inspected US firms; and the rest are audited by triennially inspected firms—13 percent by non-US affiliates of the six largest US firms (measured by number of issuer audits) and 2 percent by other US firms.

²¹⁸ Research by ERA indicates that approximately 11 percent of the large accelerated filers that filed audited financial statements with the SEC during the 18 months prior to December 31, 2016 have year ends between June 30 and November 30.

On the 1st day of June, in the year 2017, 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

APPENDIX 1

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,¹ taken as a whole,² 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").³

.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 concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,⁴ in conformity with the applicable financial reporting

¹ 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 Regulation S-X Rule 1-01(b), 17 CFR 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; see, e.g., AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

² "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

³ Paragraphs .85-.98 and Appendix C, *Special Reporting Situations*, of AS 2201, *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.

⁴ AS 2815, *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.

framework.⁵

.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*, 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**,⁶ when required, relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

The Auditor's Unqualified Report

.05 The auditor's unqualified report includes:⁷

- a. The basic elements,⁸ as described in paragraphs .06-.10;

⁵ 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.

⁶ This term is defined in Appendix A, *Definitions*, and is set in **boldface type** the first time it appears.

⁷ Appendix B provides an illustrative auditor's unqualified report.

⁸ 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; Regulation S-X Rule 2-02, 17 CFR 210.2-02; and

- 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) brokers⁹ and dealers¹⁰ reporting under Exchange Act Rule 17a-5; (2) investment companies registered under the Investment Company Act of 1940 ("Investment Company Act"),¹¹ other than companies that have elected to be regulated as business development companies;¹² (3) employee stock purchase, savings, and similar plans;¹³ and (4) emerging growth companies.¹⁴ Auditors of these entities may consider voluntarily including communication of critical audit matters as described in this standard.

- c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs .18-.19; and
- d. Information about certain audit participants, if the auditor decides to provide this information in the auditor's report, as described in paragraph .20.

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.

⁹ See PCAOB Rule 1001(b)(iii).

¹⁰ See PCAOB Rule 1001(d)(iii).

¹¹ See Section 8 of the Investment Company Act.

¹² See Section 54 of the Investment Company Act.

¹³ See Exchange Act Rule 15d-21, 17 CFR 240.15d-21.

¹⁴ See Section 3(a)(80) of the Exchange Act.

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 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

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., Regulation S-X Rules 5-04, 6-10, 6A-05, and 7-05, 17 CFR 210.5-04, 210.6-10, 210.6A-05, 210.7-05. See generally, Regulation S-X Rule 12-01, 17 CFR 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

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 the audit included:
 - (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;
 - (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

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.

- (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 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

¹⁷ See Regulation S-X Rule 2-02(a), 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.

- 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 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;
- c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
- e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the

¹⁹ See Regulation S-X Rule 2-02(a).

²⁰ See AS 3110, *Dating of the Independent Auditor's Report*.

nature of consultations outside the engagement team regarding the matter; 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 matters²¹ 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. This may be appropriate, for example, when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, 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.

.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;

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.

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

Note: 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 the audit procedures performed; (3) an indication of the outcome of the audit procedures; and (4) key observations with respect to the matter, or some combination of these elements.

- d. Refer to the relevant financial statement accounts or 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 of the financial statements 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. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole,

and we are not, by communicating the critical audit matters below, providing 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 of the financial statements 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 For each matter arising from the audit of the financial statements that:
- 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;

the auditor must document whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.²²

²² Consistent with the requirements of AS 1215, *Audit Documentation*, 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, while not affecting the auditor's opinion on the financial statements. 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
- f. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;²⁸

²³ See AS 2415, *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*.

²⁵ See paragraphs .08 and .12-.15 of AS 2820, *Evaluating Consistency of Financial Statements*.

²⁶ See AS 2820.06.

²⁷ See AS 2820.09 and .16-.17.

- 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 the supplementary information conforms to the requirements of the applicable financial reporting framework;³³

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.

³¹ See AS 3105.52-.53 and .56-.58.

³² See paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.

³³ See paragraphs .03 and .08 of AS 2705, *Required Supplementary Information*.

- k. There has been a change in an investee year end that has a material effect on the company's financial statements,³⁴ and
- 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;
- 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.

³⁴ See paragraph .32 of AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

³⁵ See paragraph .04 of AS 2710, *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.

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 hours*—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 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.

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.

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, *Communications with Audit Committees*, and Appendix B of that standard which refers to other PCAOB rules and standards.



APPENDIX B – An Illustrative Auditor's Unqualified Report Including Critical Audit Matters

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 [*titles of the financial statements, e.g., income, comprehensive income, 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 included 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 of the financial statements 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. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing 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 a new auditor reporting standard AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "final standard"), the Board is adopting related amendments to several of its other auditing standards as set out below. Language that is deleted by the amendments is struck through. Language that is added is underlined. Language that is moved without being modified, such as changes to the illustrative auditor's report to conform to the required order in the final standard, is double underlined.

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I. **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*

Introduction

~~.01 This section applies to auditors' reports issued in connection with audits⁴ 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.~~

~~⁴An 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*.~~

~~.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 management⁴ 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 presentation⁵~~

~~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 date⁷ 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 statements⁸ 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]."~~

~~f. 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.~~

~~.010 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 report² and provides reporting guidance in the following 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"), including when explanatory language is added. 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 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 2201.87, 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 explanatory⁹ paragraph (or other explanatory language) to the standard report.⁴⁰ 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.~~

~~⁴⁰ 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.⁴⁴~~

~~⁴⁴ 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.~~

~~¹²The 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.⁴³ 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.~~

~~⁴³The 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

~~.020~~ 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 ~~.0522–.1734~~).
- 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 ~~.1835–.3957~~).

~~.03~~ When the auditor expresses a qualified opinion, the auditor's report must include the same basic elements and communication of critical audit matters, if requirements of critical audit matters apply, as would be required in an unqualified auditor's report under AS 3101.

~~.0421~~ 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~~ 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 the opinion is also a critical audit matter.

Scope Limitations

.0522 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.

.0623 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.

.0724 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.³⁴⁴ 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.

³⁴⁴ 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."

.0825 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 described the basis for departure from an unqualified opinion in an explanatory separate paragraph preceding immediately following the opinion paragraph and referred to that description in both the scope Basis for Opinion section and opinion paragraphs 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.

.0926 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 [titles of the financial statements, e.g., income, comprehensive income, 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 included examining, on a test basis, evidence supporting regarding the amounts and disclosures in the financial statements. An—Our audits also included 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]

.1027 **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.

.1128 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, *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.

.1229 **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*.

.1330 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.

~~.1431~~ 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.

~~.1532~~ 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 ~~.2845~~ to ~~.3249~~ provide guidance to the auditor when financial statements contain departures from generally accepted accounting principles related to uncertainties.

~~.1633~~ **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.

.1734 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 misstatement of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. An audit Such procedures included 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

~~.1835~~ 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 ~~.1936~~ through ~~.3957~~) or an adverse (paragraphs ~~.4058~~ through ~~.4360~~) opinion. The basis for such opinion should be stated in the report.

~~.1936~~ 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.

~~.2037~~ 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.

.2138 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.⁴⁴⁵ 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.

⁴⁴⁵ 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.

.2239 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 [titles of the financial statements, e.g., income, comprehensive income, 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 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]

.2340 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 .2239 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.

.2441 ***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,⁵⁴⁶ unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB standard.

⁵⁴⁶ See footnote 415.

.2542 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 [titles of the financial statements, e.g., income, comprehensive income, 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 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]

.2643 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 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—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]

.2845 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 .2946 and .3047)
- Inappropriate accounting principles (paragraph .3148)
- Unreasonable accounting estimates (paragraph .3249)

.2946 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.

.3047 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.

.3148 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.

.3249 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]

.3354 ***Departures from generally accepted accounting principles related to changes in accounting principle.*** Paragraph .07 .17A of AS 2820, *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.

.3452 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 [titles of the financial statements, e.g., income, comprehensive income, 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.⁶⁴⁷

Basis for Opinion

[Same first and second paragraphs as the standard report—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]

⁶⁴⁷ Because this paragraph included in the example presented contains all of the information required in an explanatory separate paragraph on consistency, an separate explanatory paragraph (immediately following the opinion paragraph) as required by paragraphs .17A through .17E of this section AS 2820.08 and .12-.15 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.

.3553 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 .3654 through .3957.

.3654 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.

.3755 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.

.3856 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.

.3957 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 .3452, 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.⁷⁴⁸ If the effects are not reasonably determinable, the report should so state.⁸⁴⁹

⁷⁴⁸ See footnote 415.

⁸⁴⁹ 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 41, 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.7 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 [titles of the financial statements, e.g., income, comprehensive income, 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—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

.4461 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.

.4562 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.²⁹⁹ 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 .1835 through .3957). 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.

²⁹⁹ AS 3320.05 provides guidance to an accountant who is associated with the financial statements of a public entity, but has not audited such statements.

.46 When the auditor disclaims an opinion, the auditor's report must include the basic elements as would be required in an unqualified auditor's report under AS 3101, modified as follows:

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

(1) The name of the company whose financial statements the auditor was engaged to audit;

(2) A statement identifying each financial statement and any related schedule(s) that the auditor was engaged to audit;

b. The second section of the auditor's report must include the title "Basis for Disclaimer of Opinion."

c. Elements in paragraphs .09b-f of AS 3101 should be omitted.

Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor disclaims an opinion.

.4763 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 [titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows] income, retained earnings, and cash flows for the years then ended, and the related notes [and schedules] (collectively referred to as the "financial statements").¹⁰²⁴ 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, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements 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 Disclaimer of 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]

[Signature]

We have served as the Company's auditor since [year].

[City and State or Country]

[Date]

¹⁰²⁴ ~~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

~~.4864~~ 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

~~.4965~~ 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 auditor¹¹²² should update¹²²³ 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.¹³²⁴ 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.)

¹¹²² 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 ~~.4965~~ through ~~.5369~~ 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 ~~.5470~~ through ~~.5874~~ should be followed.

¹²²³ 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 ~~.5268~~) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

¹³²⁴ 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.

~~.5066~~ 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 ~~.5268~~) 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

~~.5167~~ 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 [titles of the financial statements, e.g., income, comprehensive income, 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 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 [titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, 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 we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the results of operations and cash flows, 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, 20X1.¹⁴²⁶

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—included 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]

¹⁴²⁵It 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

.~~5268~~ 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.

.~~5369~~ 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 report 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 [titles of the financial statements, e.g., income, comprehensive income, 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.¹⁵²⁶

Basis for Opinion

[Same first and second paragraphs as the standard report 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]

¹⁵²⁶ See footnote 647.

Report of Predecessor Auditor

.5470 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 .5574.¹⁶²⁷

¹⁶²⁷ 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

.5574 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.¹⁷²⁸ 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, 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.

¹⁷²⁸ See AS 2805, *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter."

~~.5672~~ 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 ~~.5268~~, ~~.5369~~, and ~~.5773~~ of this section.

~~.5773~~ 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

~~.5874~~ 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,¹⁸²⁹ (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.¹⁹³⁰ 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 [titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows]~~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 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 contained an explanatory paragraph or 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.

¹⁸²⁹ 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.

¹⁹³⁰ 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 Control 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, *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 included 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

~~.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.~~

~~.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. Amendments to Other Auditing Standards

AS 1205, Part of the 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 [titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows]~~income and retained earnings and cash flows~~ for the year then ended, and the related notes [and schedules] (collectively referred to as the "consolidated 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 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 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 included 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 or Includes an Explanatory Paragraph

.15 If the report of the other auditor is other than a ~~standard~~ an auditor's unqualified report or includes explanatory language, the principal auditor should decide whether the reason for the departure from the ~~standard auditor's unqualified~~ report or the explanatory language 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, *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 .0522 and .0623 of AS 31054, *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 31054.1835, .1936, and .2444.)

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, *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, *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 ~~.0522-.1532~~ of AS 31051, ~~*Reports on Audited Financial Statements Departures from Unqualified Opinions and Other Reporting Circumstances*~~, for a discussion of scope limitations.

* * *

AS 2201, *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 elements¹⁸ -

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;

be. 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. 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;

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

fg. 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;

gh. A statement that an audit included s 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; and

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

Definition and Limitations of Internal Control Over Financial Reporting

.85E The third section of the auditor's report on the audit of internal control over financial reporting must include the section title "*Definition and Limitations of Internal Control Over Financial Reporting*" and the following elements:

ae. A definition of internal control over financial reporting as stated in paragraph .A5:

bj. 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, Location, and Date

.85F The auditor's report must include the following elements:

al. The ~~manual or printed~~ signature of the auditor's firm;^{18A}

bm. 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

cn. 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 ~~[titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows]~~ 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 eCompany'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 included examining, on a test basis, evidence supporting regarding the amounts and disclosures in the financial statements.⁷ 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 and Limitations of Internal Control Over Financial Reporting 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*. 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 f, g, and h, ~~and i~~); to do so might overshadow the disclaimer.

* * *

AS 2405, *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, *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 2805.06I, 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 ~~.1835–.1936~~ 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*

* * *

.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),⁴ 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),⁴ 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 31051, *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~~4~~.

* * *

AS 2503, 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, Evaluating Consistency of Financial Statements.

* * *

AS 2505, 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 ~~.0522~~ and ~~.0623~~ of AS 3105~~4~~, *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 .09g). 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~~4~~.~~2845~~ through ~~.3249~~ to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

AS 2510, Auditing Inventories

* * *

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see paragraphs ~~.0724~~ and ~~.5167~~ of AS 31051, *Reports on Audited Financial Statements—Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

AS 2610, Initial Audits—Communications Between Predecessor and Successor Auditors

* * *

⁹ See paragraphs ~~.5470~~ through ~~.5874~~ of AS 31051, *Reports on Audited Financial Statements—Departures from Unqualified Opinions and Other Reporting Circumstances*, for reporting guidance.

* * *

AS 2705, 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, including appropriate titles, an auditor might use in these circumstances.

* * *

AS 2710, 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, including an appropriate title, 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, *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, *Management Representations*

* * *

¹⁵ See paragraph .5574 of AS 31054, *Reports on Audited Financial Statements Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

¹⁸ See AS 31054.0522-.1734.

* * *

AS 2810, *Evaluating Audit Results*

* * *

⁷ If the financial statements contain material misstatements, AS 31054, *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 31054.1835 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~~4~~, 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~~4.2441–.2744~~.

* * *

.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~~4~~ indicates that the auditor should express a qualified opinion or a disclaimer of opinion.²¹

²¹ AS 3105~~4.0522–.1734~~ contains requirements regarding audit scope limitations.

* * *

Appendix B

¹ If the financial statements contain material misstatements, AS 3105~~4~~, *~~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~~4.1835~~ 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~~4~~, *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"*

.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 3104~~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, *Consideration of Materiality in Planning and Performing an Audit*, and AS 3105~~4~~.19~~36~~).

* * *

AS 2820, *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 entity⁶ 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 3104 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 3104 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~~4~~, *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~~1~~ and .08~~1~~ and AS 3104 .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~~1~~ and .10~~1~~ and AS 3104 .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, *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 .5470–.5773 of AS 3105¹, *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, *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 an auditor's report described in this section is filed with the U.S. Securities and Exchange Commission, the auditor is required to include in the auditor's report the basic elements and, for reports under subparagraph .01a, communication of critical audit matters, 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 3101.08h, 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 3101.08h, 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 requirements for the auditor's report, 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~~4.4864~~). 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~~4~~, 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 thereon³⁶ 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, *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*.

- 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~~1.5268~~ and .5369.

* * *

AS 3310, *Special Reports on Regulated Companies*

* * *

.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 .08~~e~~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, 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 .2444 through .2744 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 [titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows]~~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, 1920X5, 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

[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 [titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows] for the years ended December 31, 20X2, and 20X1, and the related notes [and schedules] (collectively referred to as the "20X3, 20X2, and 20X1 consolidated financial statements") (none of which are presented herein); and we expressed unqualified opinions on those 20X3, 20X2, and 20X1 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, 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 3105~~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

* * *

.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~~4~~, Reports on Audited Financial Statements, Departures from Unqualified Opinions and Other Reporting Circumstances).

* * *

AS 4105, Reviews of 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 If the accountant's review report is included in a filing with the SEC or another regulatory agency, the 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 Interim Financial Information" 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.

cg. 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:

ae. A statement that the interim financial information is the responsibility of the entity's management.

bd. A statement that the review of interim financial information was conducted in accordance with the standards of the PCAOB.

ce. A description of the procedures for a review of interim financial information.

df. 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.

e. 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.

.37D The accountant's review report must include the following elements:

a~~h~~. The ~~manual or printed~~ signature of the accountant's firm.^{24A}

bi. 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.^{24AB}

cj. 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).

^{24AB} ~~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 Interim [*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, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). 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 Interim [*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, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). 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 Interim [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, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). 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 principles³² 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, including an appropriate title (immediately following the paragraph describing the results of the review), 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,~~ including an appropriate title (immediately following the paragraph describing the results of the review), emphasizing the matter disclosed in the interim financial information. The following is an example of such a paragraph.

[Appropriate Title]

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. The auditor should add an explanatory paragraph, including an appropriate title, to the report. ~~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. ~~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, *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 refer¹⁸ 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.

* * *

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* * *

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. Amendments to Auditing Interpretations

AI 11, Using the Work of a Specialist: Auditing Interpretations of AS 1210

* * *

.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 .1835 through .4360 of AS 31054, *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 31054.0522–.0926 and AS 31054.4461–.4763.

* * *

AI 16, Auditing Accounting Estimates: Auditing Interpretations of AS 2501

* * *

.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 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

* * *

.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 .2845 through .3249 of AS 31054, *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 20: Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710

* * *

.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, *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~~

~~⁵Unless 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."~~

* * *

AI 23, Reports on Audited Financial Statements: Auditing Interpretations of AS 3101 Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of AS 31051

* * *

~~.01 Question— Paragraph .0724 of AS 31051, *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 reports 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 includeds 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 included examining, on a test basis, evidence supporting regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also includeds 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 ~~A~~ 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 included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~A~~ 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~~ 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 included examining, on a test basis, evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our ~~audit also included~~ 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~~4~~.~~5874~~ 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 ~~1829~~ of AS 3105~~4~~ 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~~4~~.5874. (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 31054.5874. 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 31054.5874?

.75 *Interpretation*—No. AS 31054.5874 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 24, *Special Reports: Auditing Interpretations of AS 3305*

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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 31054, *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~~4.1835–2744~~ and ~~.4058–.4360~~.

* * *

.86 If there is no such agreement, the auditor should follow the guidance in AS 3105~~4.1835–2744~~ and ~~.4058–.4360~~.

* * *

AI 25, Association with Financial Statements: Auditing Interpretations of AS 3320

* * *

.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

* * *

.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 .0724 of AS 3105~~4~~, ~~*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.

* * *