The Public Company Accounting Oversight Board ("PCAOB") recently proposed new auditing standards that, if adopted, would substantially expand the content of audit reports. Under the current model for audit reports, auditors give a "pass/fail" assessment of whether a company’s financial statements present fairly, in all material respects, its financial position. Auditors are not required to disclose in these current audit reports any issues that arise during the audit process. Without eliminating the "pass/fail" component of the current model, the new standards would impose two new requirements on auditors that are designed to enhance the usefulness of audit reports.

**Critical Audit Matters**

First, auditors would be required to include discussions of "critical audit matters" or "CAMs." The new standards generally define "CAMs" as those matters addressed during the audit that:

- Involve the most difficult, subjective, or complex auditor judgments;
- Pose the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
- Pose the most difficulty in forming an opinion on the financial statements.

For example, a CAM may include decisions regarding valuation of a financial instrument with little or no market activity, as well as other matters of such importance that they are included in engagement completion documents, which summarize the significant issues and findings from the audit and are required to be communicated to the audit committee.

**Other Information**

Secondly, the proposed standards would require auditors to evaluate what is generally referred to as
“other information.” “Other information” is information presented in a company’s annual report outside of the audited financial statements (such as subjective analysis contained in a company's MD&A). The auditor would be required to discuss with management, and then with the audit committee, any concerns the auditor has regarding the consistency between a company’s other information and its financial statements. An auditor would also be required to disclose the results of this review in its report.

INITIAL REACTIONS

Although some investors and other interested parties have expressed receptiveness to enhancing auditor reporting, reactions to the specific alternatives proposed by the PCAOB have been mixed.

Reporting companies, in particular, have criticized the proposed standards for a number of reasons. Foremost, companies have argued that the proposed enhancements would lead to substantially increased fees for audit services and that these higher fees may not be justified by the benefits to investors of the additional disclosure. In addition, companies are concerned about disclosing the auditor’s analyses and judgments in one of a company’s primary communications with shareholders—the annual report. Because these types of discussions have historically been provided by management on behalf of the company, there is a concern that the additional disclosure could lead to confusion as to whether management or a company's auditors are responsible for speaking for the company on these matters. At least one government agency, the Government Accountability Office, and even some members of the PCAOB have expressed similar concerns about blurring the lines between auditors and the companies they serve.

Auditors are focused on potential increased litigation risk. A requirement that auditors disclose their subjective analysis in companies’ annual reports could subject auditors to liability in areas in which they currently have limited exposure, including under the anti-fraud provisions of the federal securities laws. Auditors have characterized this as an unfair allocation of responsibility because they, unlike management, are professionally trained in accounting instead of business operations and are not necessarily skilled in analyzing trends and uncertainties affecting a business’s operating results.

Furthermore, under current auditing standards, auditors function as companies’ partners in ensuring the accuracy of financial information. Auditors have expressed concerns that the proposed standards could impair transparency and openness in discussion between the auditor, audit committee, and management. If the content of their communications during the audit is required to be disclosed, company personnel may avoid enlisting the assistance of auditors when addressing complex financial questions. As a result, the proposed standards could have an unintended negative effect on audit quality.

In contrast to reporting companies and auditing firms, institutional investors have generally responded favorably to the PCAOB’s proposals to enhance audit reports. Nonetheless, institutional investors remain concerned about the potential cost the proposals could impose on companies.

COMMENT PERIOD; EXPECTATIONS

The public comment period for the proposed standards is scheduled to end on December 11, 2013. Given the proposed standards’ wide-ranging impact on the audit process, and the initial reactions of many companies and audit firms, we anticipate that the comment period will be extended. As a result of the initial reactions and the anticipated high volume of comments regarding the proposals, it is likely that any new standards will not be in the form currently proposed.
For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

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