

Center for Financial and Accounting Literacy

PCAOB Auditor Reporting Requirements

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Investors have more information than ever before about the accounting firms that audit public companies, but some say it is still not enough. In the aftermath of the financial crisis, investors are requesting more information about the firms and their audit work, so as to better assess the quality of the audits and related risks. These requests are getting the attention of both regulators and accounting firms. The Public Company Accounting Oversight Board (PCAOB) has issued a Concept Release about changes to the auditor's reporting model, and at least one major accounting firm has issued a public report about how it maintains and enhances the quality of its audits. This Special Report discusses the information gap, the extent to which voluntary reporting can help close the gap, and what is needed to step up to the broader issues.

What reports are required now?

Under rules that took effect in 2010, firms registered with the PCAOB are required to report certain information to the Board which in turn makes the reports available to investors and the general public. The information currently available about audit firms includes annual and special reports as summarized below.

- *Annual reporting.* Accounting firms that are registered with the PCAOB must file annual reports that include information about audits of issuers subject to SEC reporting, including audit reports issued in the past year, disciplinary actions and fees.
- *Special reporting.* Audit firms need to file special reports within 30 days after the occurrence of certain events, such as a change in the firm's name or ownership structure or certain administrative, legal or disciplinary proceedings. These disclosures are designed to help investors and regulators better assess the risks associated with audit firms and their audit opinions. Examples of reportable current events that might serve as "red flags" to investors include the following:
 - An accounting firm withdraws an audit report, and the related issuer has not complied with its requirement to report that event on a Form 8-K.
 - A firm becomes aware that an issuer has made use of the firm's name in an unauthorized manner without the required consent of the firm.
 - A firm (or any of its partners, managers, or members) becomes a defendant in certain criminal, governmental, administrative or disciplinary proceedings.
 - A firm hires an employee, admits a partner, or contracts to work with a person or entity who is the subject of certain disciplinary sanctions.
 - Any of certain professional licenses or certifications is revoked, suspended or made subject to conditions or contingencies.

Both the annual and special reports are available on the PCAOB's website, subject to certain exceptions for information for which a firm requests confidential treatment.

What additional information is needed?

In addition to information about their firms, auditors issue a report on each audit. These reports are relatively brief and the wording uses phrases and expressions that tend to be very similar, even across companies that face very different risks. As discussed in our special report on [Investor confidence in audits - what more can be done?](#), one of the key improvements suggested by a high-level advisory committee to the US Treasury Department is for the accounting profession to migrate toward an expanded "plain-English" audit report that might contain more explanations of the audit process and more findings. This appears to be exactly what today's investors want - both in general and for specific audits. For example, a group of institutional investors recently asked the PCAOB to require more information about the procedures and findings on specific audits, thereby opening up more direct communications between auditors and investors.

The core issues underlying these requests touch on the very purpose and value of independent audits and the basic "pass-fail" audit report that has been in existence for many years. Essentially, this report conveys an opinion on whether the financial statements are prepared in accordance with US generally accepted accounting principles (US GAAP.) Investors fault today's "pass-fail" opinions for failing to alert them to the bankruptcies, takeovers, and bailouts of the recent financial crisis. In lieu of, or in addition to, basic "pass-fail" audit reports, investors told the PCAOB they would like to have:

- More information about what the auditor did during the course of the audit, what the auditor thinks of management's assertions, and whether there were any areas of disagreement between management and the auditors.
- Assurances or attestations about information that lies outside the financial statements, such as earnings releases and the management discussion and analysis (MD&A) portion of annual reports.

The PCAOB has responded to the requests with Concept Release 2011-003. Among other things, this Release explores the feasibility of an "Auditor's Discussion and Analysis" (AD&A). The Board is currently reviewing the comments received on the Release and hopes to issue a more specific proposal in 2012.

Can voluntary reporting by audit firms fill the gap?

While waiting for the PCAOB's next steps, at least one major global firm, PricewaterhouseCoopers (PwC), has taken the lead by issuing a voluntary report on its audit quality. Entitled "Our Focus on Audit Quality," PwC's report is addressed to capital market stakeholders. This report discusses the elements needed for a foundation that will support audit quality, (including independence, integrity, core values, and a guiding philosophy for dealing with complex accounting transactions for which more than one accounting treatment is acceptable).

The report also highlights the firm's philosophy of continuous improvement. The specific steps mentioned in this section include:

- Providing audit partners with more manageable workloads.
- Adapting partner compensation to provide positive reinforcement for sustained audit quality.

- Implementing a "global audit transformation program" that features risk-based audit software and an experimental approach that allows audit teams to assign some of the more routine audit activities to staff located in centralized service centers.
- Using locally-conducted year-end training sessions to share best practices, for example, on additional matters to consider when auditing difficult areas such as fair value measurements.
- Expanding training materials to raise awareness of the broader issues regarding audit quality that are being discussed by the PCAOB and regulators outside the U.S. today.

Will voluntary reports on audit quality fully satisfy the demands of today's investors? Not likely. But at least they can help to open a dialogue about whether the steps are directionally correct and, if not, which areas need to be addressed more broadly by regulators and the accounting profession.

Stepping up to the broader issues

Arguably the biggest issue to be addressed is whether the training and standards that define the profession today are appropriate for a world in which investors are demanding that auditors create and communicate new information as opposed to providing assurance on information created by others.

If the current partners and staff of today's audit firms lack the necessary analytical and communications skills, then PCAOB regulations alone will not succeed in effectively closing the gap between the services auditors provide today and the ones that investors want and need.

But the PCAOB is well positioned to play a major role in enacting and enforcing the necessary changes in standards as well as rules. The PCAOB has the power to enforce any new requirements under the Sarbanes-Oxley Act of 2002. Under this Act, the Board is, in effect, the auditor of the auditors. It is responsible for registering and inspecting accounting firms that audit public companies whose stock is traded on any US exchange. It also sets applicable auditing standards, and it can conduct investigations of and initiate disciplinary proceedings against registered firms.

Currently, the PCAOB has a full agenda that includes initiatives on auditor reporting, auditor independence, audit firm rotation, and requirements to disclose the names of audit partners in audit reports. Many of the changes under consideration today reflect the recommendations in the final report of the US Treasury Advisory Committee on the Auditing Profession. Among other things, the Advisory Committee, also known as the Paulson Committee, suggested that the PCAOB should require that the largest audit firms prepare and privately submit audited financial statements adhering to Generally Accepted Accounting Principles to the PCAOB by 2011. The Paulson Committee also recommended the development of key quality indicators for audit firms.

Eventually, perhaps the PCAOB might require accounting firms to provide periodic reports that combine audited financial statements, key quality indicators, and accompanying commentary similar to the PwC quality report in addition to the inclusion of an AD&A section in their audit reports. That would add up to a tall order for accounting firms, but changes appear to be inevitable in today's dynamic environment as the dialogue continues.

Answers to Frequently Asked Questions (FAQs)

Where can investors find the reports filed under the PCAOB's auditor reporting rules?

The reports are available at http://pcaobus.org/Registration/rasr/Pages/RASR_Search.aspx.

What information do audit firms need to report annually?

Among other things, the firms need to report:

- The nature of the reports they issued for companies subject to SEC reporting requirements, (such as whether the entities were limited to employee benefit plans that file on Form 11-K), additional details (by issuer and date) of the audit reports that apply to public companies' financial statements, breakdowns of the fees billed to issuer audit clients (audit services, other accounting services, tax services and non-audit services), and the number of audit firm personnel who exercised the authority to sign the firm's name to an audit report during the period.
- Alternatively, if the firm did not issue any reports for companies subject to SEC reporting requirements, then it would need to report details of any such reports that it played a "substantial role" in preparing or furnishing.

What about alliances?

Audit firms must report memberships in (or affiliations with) any network, alliance, association or other arrangement that: (a) licenses or authorizes audit procedures, manuals or related materials; (b) licenses or authorizes the use of a name in connection with the providing of audit or accounting services; (c) markets audit services or through which joint audits are conducted, or (d) employs or leases personnel to perform audit services.

What about the audit firm's financial health?

An audit firm will need to file a special report when it (or its partners or employees) are charged in certain criminal, civil or administrative proceedings, but the PCAOB and SEC did not propose any requirement to disclose any information about the firm's financial condition.

Helpful Links

PCAOB Concept Release on Changes to Auditor's Reporting Model

<http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx>

PwC Report: Focus on Audit Quality <http://www.pwc.com/us/en/audit-assurance-services/publications/our-focus-on-audit-quality.jhtml>

Deloitte and Touche 2011 annual review <http://public.deloitte.com/media/0566/index.html>

Deloitte and Touche 2011 Transparency report http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Content/Articles/AERS/us_aers_Investor_Transparency_Report_Mar2011.pdf

Ernst & Young Transparency report <http://www.ey.com/UK/en/About-us/About-EY---Transparency-Report>

KPMG International annual review

<http://www.kpmg.com/Global/en/WhoWeAre/Performance/AnnualReviews/Pages/default.aspx>

PwC Global Annual Review <http://www.pwc.com/gx/en/annual-review/index.jhtml>

Final Report on the Advisory Committee on the Auditing Profession

<http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>

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