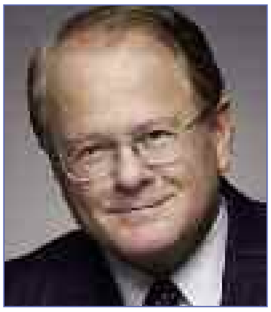
PCAOB proposals promise increased transparency in audit industry



Thomas Dubbs
Senior Partner
Labaton Sucharow LLP

On June 21, 2011 the Public Company Accounting Oversight Board (PCAOB), whose mission is the regulation of US auditing firms, took the first step towards reforming transparency requirements in auditor reports by issuing for public discussion a concept release outlining potential changes to auditing standards. The board will also convene a public roundtable to discuss the concept release in the third quarter of 2011.

James R. Doty, PCAOB Chairman characterised the release as "a significant step for investor protection in response to the financial crisis, and a first step toward an holistic consideration of reforms designed to foster the relevance, transparency and reliability of the audit process."

Because auditor reports offer substantial insight into a company's health, the PCAOB believes that it is vital to reform the way financial information is communicated to investors. They have targeted potential changes at making audit reports more comprehensive in their discussion of a company's overall status and more understandable to an audience which may not have significant accounting/auditing backgrounds.

Currently, the auditor's opinion included in every annual report is essentially a binary pass/fail showing whether, in the view of the auditor, a company is honestly presenting its financial statements. Usually, the report does not go into further depth or discuss aspects of the company outside of the financial statements other than to highlight a situation where the company is in enough danger that it may completely fail. However, the auditor's status as a third party and its extensive knowledge of the company mean that it could offer a much greater depth of information. Based on the large number of financial institutions that failed or needed a government bailout during the financial crisis, in spite of receiving clean audit opinions, this deeper information must be available to investors so that they can make informed investing decisions.

"Because auditor reports offer substantial insight into a company's health, the PCAOB believes that it is vital to reform the way financial information is communicated to investors."

The Board has targeted a number of areas for potential change. The most far-reaching of which would be a new Auditor's Discussion and Analysis Report, a supplement to the main audit opinion. The Analysis would likely cover such areas as the auditor's understanding of the judgments, estimates and accounting policies that are used to formulate the company's financial statements and whether the firm's management is using an "aggressive" financial reporting standard.

Other proposals include required use of highlighted emphasis paragraphs in which auditors would point out the most significant portions of the financial statements, drawing investor attention, and additional commentary on areas outside the statements which explain the auditor's findings such as earnings releases.

The Board also expects to generally clarify the language used in the standard auditor's report for consistency and accessibility.

Separate from the June 21st proposals, Chairman Doty has also put forward the idea of term limits for auditing firms, requiring companies to change auditors every few years, but such a rule will be addressed in a future proposal as it is still in development.

Although auditors did not cause the financial crisis, their treatment of unstable financial firms certainly

played a role and, as such, they have been under scrutiny not only in the United States, but in the UK and Europe as well, with the House of Lords and the European Commission looking into reforms of their own.

Improved transparency of the auditing process can only aid investors of all stripes in making fund management decisions. Indeed, the PCAOB's March Investor Advisory Group survey found that many investors believe that current audit reports do not provide valuable information that is integral to understanding financial statements and that respondents skim the audit report quickly for departures from the standard unqualified report – viewing the report as boilerplate.

Respondents elaborated by saying that they would like to see more information about the methodology of the auditor and details of the company's practices which led up to the financial statements.

Although auditors have long been reluctant to accept an expanded role due to potential legal liability and increased audit fees, recent difficulties with Chinese companies, which listed on United States exchanges, received a clean audit statement and were subsequently found to have engaged in numerous accounting falsifications, shows that changes in the auditing industry remain necessary. Even the Association of Chartered Certified Accountants, a global accounting group, lent its support to expanding the role of auditors in a paper released in May.

The Board will put forth final changes by the end of 2011 and expects to have the resulting new rules enacted before the end of 2012, pending Securities and Exchange Commission approval.

Finally, if these proposals carry through, they will make the annual audit report a valuable piece of the investing puzzle rather than easily-ignored boilerplate.