

Agenda Item 8

Standing Advisory Group Meeting

June 21-22, 2004

**Potential Project – Auditor's Responsibility for
Communications to Investors Containing Financial Information**

The Standing Advisory Group (or "SAG") will discuss issues relating to an auditor's responsibility for communications to investors containing financial information. This paper contains background information on this topic and discussion questions for consideration at the SAG meeting.

Overview

The Board is considering whether to undertake a project on the auditor's responsibility with regard to communications, by issuers to investors, which contain financial information. The purpose of the discussion with the SAG is to review existing auditing standards in this area; discuss a number of practice issues relating to the auditor's responsibilities in this area; obtain SAG members' views on the priority of such a project in relation to other projects currently on the Board's standard-setting agenda; and suggest possible direction for any such project. This project, if it were undertaken, would require close coordination with the United States Securities and Exchange Commission ("SEC"). For example, some of the questions to be discussed may impact the timing in which information is provided to the market, an issue that we understand is of extreme importance to the SEC.

This paper was developed by the staff of the Office of the Chief Auditor in order to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.

Background

An auditor's report on audited financial statements is the most common form of auditor involvement in a communication to investors containing financial information. Issuers must include the auditor's report in certain communications to investors, such as in the annual report filed on Form 10-K. Also, an auditor is associated with the *other information* in the Form 10-K since his or her report on the financial statements is included in the filing. Because of that association, existing auditing standards address an auditor's responsibility for *other information* included in annual reports or other documents that also contain audited financial statements and the auditor's report.

Specifically, these standards require the auditor to read the *other information* and to consider whether that information is materially inconsistent with the information appearing in the audited financial statements. However, the auditor has no obligation to perform any procedures to corroborate the *other information* contained in the document. Instead, the responsibility is limited to reading the document and considering whether any information is materially inconsistent with the audited financial statements or whether there is a material misstatement of fact based on the auditor's knowledge gained as part of performing the audit. If no material inconsistencies are found, the auditor remains silent in his or her report with respect to the other information. The auditor takes no responsibility for, and provides no assurance regarding, the reliability of the information presented in the annual report (other than the audited financial statements).

Although existing auditing standards address the auditor's procedures in connection with *other information* contained in an annual report, the standards consider all information contained in the report the same, regardless of whether the *other information* comprises financial or nonfinancial information. Accordingly, the auditor's required procedures for all types of other information included in the annual report are the same. Since financial information contained in an annual report is more closely related to the information contained in the audited financial statements, questions have arisen about whether the auditor should perform more extensive procedures and take on some degree of responsibility for financial information—and not for the non-financial information—included in an annual report.

Existing standards address an auditor's responsibility for interim financial statements included in an issuer's quarterly report filed on Form 10-Q or Form 10-QSB.^{1/} Consistent with SEC requirements for timely interim reviews of financial

^{1/} See SAS No. 100, codified as AU sec. 722, "Interim Financial Information." The quarterly 10-Q form is required to be filed for each of the first three quarters of the fiscal year by issuers of securities registered pursuant to the 1934

information, the standards require the auditor to perform certain limited review procedures in connection with the quarterly statements. Neither the auditing standards nor the SEC requires the auditor to issue a written report on a review of interim financial information. However, the SEC requires that a written review report be filed with the Form 10-Q or Form 10-QSB if, in any filing, the issuer states that the interim financial information has been reviewed by an independent public accountant. (To be clear, the SEC requires that the auditor perform a timely interim review. By filing a Form 10-Q, the issuer implicitly asserts that the auditor's required review was complete at the time of filing. However, the SEC does not require the auditor to, and most auditors do not, issue a review report at the conclusion of every review.)

However, existing auditing standards do not address an auditor's responsibility for financial information provided by an issuer in other types of investor communications, such as in a Form 8-K.^{2/} In most cases, an auditor is not associated with such information; thus, having no responsibility for it is appropriate. In other cases, however, even though an auditor is not *directly* associated with such information, he or she often is indirectly associated with it, particularly when an issuer makes its earnings release on a Form 8-K.

Existing auditing standards do not address the auditor's involvement in an issuer's earnings releases. However, as a practical matter, most auditors are involved to some extent with quarterly earnings releases. This and other practice issues have led to questions about whether an auditor should have some responsibility for this type of financial information and whether he or she should be required to report on that information in some way.

The remainder of this paper provides a more detailed discussion of these and other related issues. In addition, it highlights discussion questions on which the Board would like input from the Standing Advisory Group.

Securities Act who are required to file annual 10-K forms and by issuers of securities registered under the 1933 Securities Act. Form 10-QSB is required to be filed for each of the first three quarters of the fiscal year by issuers required to file Form 10-KSB (small business issuers).

^{2/} For an overview of information about the contents of a Form 8-K, see the subsequent section of this briefing paper, "An Auditor's Responsibility for Information Included in Other Issuer Communications to Investors."

An Auditor's Responsibility for Information Contained in an Annual Report

An issuer's annual report filed on Form 10-K contains a variety of information in addition to the audited financial statements and the auditor's report thereon. For example, an annual report also includes other information, such as a chairman's or president's letter, a ten-year financial summary, management's discussion and analysis ("MD&A"), and a listing of officers and directors.

SAS No. 8, Other Information

SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, as amended by SAS No. 98, *Omnibus Statement on Auditing Standards—2002* (AICPA, *Professional Standards*, Vol. 1, AU sec. 550) provides direction on an auditor's responsibility for other information included in an annual report in addition to the audited financial statements and the auditor's report thereon.^{3/} Earnings releases are excluded from the scope of SAS No. 8.

SAS No. 8 states that the auditor's responsibility with respect to other information included in the annual report does not extend beyond the financial information identified in his or her report and that the auditor has no obligation to perform any procedures to corroborate other information contained in the annual report. SAS No. 8, however, instructs the auditor to 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 audited financial statements.^{4/}

^{3/} SAS No. 8 does not apply when the financial statements and report appear in a registration statement filed under the Securities Act of 1933. In addition, SAS No. 8 does not apply to other information on which the auditor is engaged to express an opinion.

^{4/} If the auditor has subjected certain other information (such as supplementary information) to auditing procedures applied in the audit of the basic financial statements, the auditor may express an opinion on whether the information is fairly stated in all material respects in relation to those financial statements taken as a whole. In those circumstances, the auditor's report on the information should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, paragraphs .12 and .14 (AU sec. 551), provide guidance to the auditor on how to report in these situations.

If the auditor concludes that there is a material inconsistency, SAS No. 8 requires the auditor to determine whether the financial statements, the auditor's report, or both requires revision. If the auditor concludes that neither the report nor the financial statements requires revision, SAS No. 8 instructs the auditor to follow several steps to resolve the inconsistency. First, the auditor should request the client to revise the other information in the annual report to be consistent with the audited financial statements. If the other information is not revised to eliminate the material inconsistency, SAS No. 8 requires the auditor to consider other actions such as (a) revising the auditor's report to include an explanatory paragraph describing the material inconsistency; (b) withholding the use of the auditor's report in the document (*i.e.*, refusing to consent to the inclusion of the auditor's report in the issuer's Form 10-K); or (c) withdrawing from the engagement. The action the auditor takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

If, while reading the other information for consistency with information appearing in the financial statements, the auditor becomes aware of information that he or she believes is a material misstatement of fact rather than a material inconsistency with the audited financial statements, the auditor has fewer alternatives for resolution. SAS No. 8 directs the auditor to discuss the matter with the client. In connection with this discussion, the auditor should consider that (a) he or she may not have the expertise to assess the validity of the statement; (b) there may be no standards by which to assess the presentation; and (c) there might be valid differences of judgment or opinion. If the auditor concludes he or she has a valid basis for concern, SAS No. 8 directs the auditor to suggest that the issuer consult with some other party whose advice might be useful to the issuer, such as the issuer's legal counsel.

If, after discussing the matter with the issuer, the auditor concludes that a material misstatement of fact remains, SAS No. 8 states that the action the auditor takes will depend on his judgment in the particular circumstances. Further, that standard instructs the auditor to consider steps such as notifying the client in writing of his or her views concerning the information and consulting his or her legal counsel as to further appropriate action in the circumstances. (Unlike the situation in which there is a material inconsistency with the financial statements, the auditor would not modify his or her audit report for this situation.)

Related Practice Issues

As previously discussed, SAS No. 8 treats all information—both financial and non-financial—included in an annual report the same. The auditor has no responsibility for this information and has no obligation to corroborate that information. Clearly, financial information has a closer relationship to the information included in the financial statements that the auditor has audited. For example, in practice, many auditors include documentation in their audit working papers that cross-reference or reconcile

the financial information included in MD&A^{5/} with the audited financial statements. This goes beyond the "reading" required by SAS No. 8 and occurs on a voluntary basis. Some auditors go even further and support the financial information in MD&A in such a manner that it is "comfort-letter-ready" at the time the Form 10-K is issued.^{6/}

Auditors are permitted to comment in their comfort letter only on matters to which their professional expertise is substantially relevant. A prime example of these matters is the financial information included in MD&A, which leads underwriters to frequently request the auditor to "comfort" this information when it is incorporated by reference into a registration statement. For companies that expect to issue securities in the upcoming year in which an underwriter would be expected to request a comfort letter from the auditors, sometimes the auditor will support the financial information in MD&A in a manner that is comfort-letter-ready at the time the 10-K is filed, as a way of most efficiently preparing for the anticipated comfort letter request. The documentation and extent of procedures in such cases is far more extensive than that required by SAS No. 8 and, therefore, entails a meaningful amount of incremental work on the part of the auditor. This additional work is rarely undertaken without additional fees. Either the issuer agrees to compensate the auditor as part of the audit of the financial statements for these additional procedures on MD&A (in advance of the underwriter's request) or the auditor elects to perform these procedures on his or her own accord with the expectation that the cost will be recaptured at the time a comfort letter is requested and issued.

Discussion Questions –

1. Does SAS No. 8, in its present form, continue to adequately serve the public interest, or should the auditor have a higher degree of required involvement for

^{5/} Management's discussion and analysis ("MD&A") of financial condition and results of operations is not covered by the accountant's report, but the accountant is responsible for reading it. The text of requirements for MD&A includes, for example, management's discussion of liquidity, capital resources, and results of operations for the latest three years. Additionally, management should include other information that is necessary for understanding the entity's financial condition, changes in financial condition, and results of operations and, if appropriate, discussions of relevant reportable segments or other business divisions and the company as a whole.

^{6/} "Comfort- letter-ready" means the following: For securities offerings under the Securities Exchange Act of 1933, underwriters have an obligation to perform some type of due diligence to support that they had reason to believe that there were no material omissions or misstatements in the registration statement. As part of discharging this responsibility, underwriters frequently ask for a letter from the auditor, commonly referred to as a "comfort letter."

financial information in addition to the audited financial statements contained in an annual report versus non-financial information? Why? How are costs and benefits of auditor involvement for financial information best balanced?

2. If SAS No. 8 should be updated, should the auditor's involvement with financial information in the annual report be limited to reconciling that financial information with the audited financial statements, or otherwise vouching the financial information to its original source, but not taking any responsibility for such financial information (i.e., not expressing any kind of assurance in the auditor's report covering this information)?
3. If SAS No. 8 should be updated, should the auditor's involvement with financial information in the annual report be so extensive that the auditor should take some kind of responsibility for this information? Existing attestation standards, in AT sec. 701, address the auditor's separate engagement to review or examine MD&A. However, to date, these engagements have rarely been performed, largely because issuers haven't requested them, presumably due to the associated cost and lack of any perceived need. Do the added benefits of an auditor taking responsibility for financial information in the annual report (i.e., expressing some kind of assurance) outweigh the added costs?
4. Should the auditor's audit report on the financial statements explicitly refer to the auditor's responsibility (or lack thereof) for other financial information in the annual report or the results of the auditor's work? How would the costs versus benefits of this reporting best be balanced?

Other Information in Electronic Sites Containing Audited Financial Statements

The Board's interim standards include an interpretation of SAS No. 8 that addresses the auditor's responsibility for other information included in an electronic site, which would include the SEC's EDGAR system, issuer Web sites, and other areas of the internet and would encompass annual reports, financial statements and other information, as well as press releases and other promotional material. The interpretation takes the position that electronic sites are a means of distributing information and are not "documents" as SAS No. 8 uses that term. Therefore, SAS No. 8 does not require auditors to read information contained in electronic sites or to consider the consistency of other information in electronic sites with the original documents.

Discussion Question –

5. Does this interpretation of SAS No. 8 need to be updated? If so, how could the "electronic site" and types of information for which the auditor would have some

involvement be appropriately limited? If the auditor took some kind of responsibility for this information (i.e., expressed some kind of assurance), how would the auditor's assurance be communicated—within the electronic site or otherwise?

An Auditor's Responsibility for Information Included in Other Issuer Communications to Investors

The SEC requires an issuer to file a Form 8-K when certain circumstances exist, including when there is (a) a change in control of an issuer, (b) a significant acquisition or disposition of assets outside the normal course of business, or (c) a change in auditors. An issuer also furnishes its earnings releases on a Form 8-K. As with the information included in an annual report, the information included in a Form 8-K ranges from financial to non-financial information.

Because an auditor's report on audited financial statements is not included in a Form 8-K, the auditor is not associated with such information; therefore, existing standards^{7/} do not address an auditor's responsibility for such information.

Related Practice Issues

Questions have arisen about whether an auditor should have responsibility for other types of financial information, especially when it relates to an auditor's possible responsibility for an issuer's earnings release.

First, some auditors use the date of the fourth-quarter earnings release as the date of their audit reports. Auditing standards require an auditor to use the date that fieldwork is *completed* as the date of his or her audit report; in practice, most auditors interpret this requirement as the date fieldwork is *substantially complete*. Therefore, dating the report on the same day as the earnings release date signals that the auditor considers his or her fieldwork to be substantially completed on that date. Many issuers, as well as some users, view this as an implied auditor imprimatur on their earnings release information.

Second, although an auditor currently has no formal responsibility to perform procedures in connection with information contained in an issuer's earnings release, as a practical matter, most auditors perform some procedures, either at their election or the issuer's request. For example, several audit firms suggest, in their internal methodology, that as much of the auditor's SAS No. 100 review of interim financial information should be complete as possible. Paralleling the SAS No. 100 requirement

^{7/} SEC regulations, however, impose certain responsibilities on an auditor when a change in auditors is reported on a Form 8-K.

that the auditor obtain evidence that the interim financial information in the Form 10-Q agrees or reconciles with the accounting records, many auditors elect to reconcile the issuer's earnings release information with the accounting records. Further, most issuers want private assurance from the auditor prior to earnings release that the auditor is "signed off" on the numbers, especially those for the fourth quarter. Although the majority of fourth-quarter earnings releases are unaudited, a few issuers wait to release fourth-quarter earnings until the earnings release can be issued as "audited" information.

However, the information in periodic reports (i.e., either Form 10-K or 10-Q) is more extensive than that contained in earnings releases, and it would be difficult to completely eliminate the gap between the earnings release date and the filing of the report without simply delaying the release of earnings information to the market. Likewise, it might be equally difficult to mandate that the auditor take responsibility for the earnings release information in the same manner that the auditor takes responsibility for the financial statements filed in a periodic report.

There is discussion also about the idea that an auditor currently is providing at least implied assurances that an issuer's earnings release is fairly stated. Accordingly, it might be more appropriate for the auditor to provide explicit assurance by stating his or her responsibility for the information contained in the earnings release and his or her views on whether it is fairly presented. Yet, without any required involvement in an issuer's earnings release, many auditors currently feel they have little leverage when they identify information in an earnings release that they believe is materially misleading. In these circumstances, the auditor will, of course, bring the matter to the attention of management and, if not resolved with management, the auditor might decide to bring the matter to the attention of the audit committee. However, in the event that the company proceeds with the earnings release unaltered, auditors have few practical alternatives in response.^{8/} For example, audit firms don't issue their own press releases commenting on issuer's earnings releases. The auditor can always resign in response to management's and the audit committee's handling (or mishandling) of these types of matters. However, to the extent that such concerns arise with the fourth-quarter earnings release, many auditors would feel bound to complete the audit they were engaged to conduct. At that point in time, it would be impossible for the company to engage another auditor to complete the audit of the financial statements and meet the issuer's filing deadlines for its required annual report. Some auditors have been advised by legal counsel that they have no responsibility for a client's earnings releases. If the auditor is required to assume some kind of responsibility for the information

^{8/} However, in such a situation, the auditor might have responsibilities under Section 10A of the Securities Exchange Act of 1934.

contained in earnings releases, more effective responses should be provided to the auditor in case the auditor believes that the earnings release is materially inaccurate.

This issue of auditor involvement in earnings releases is implicated in several recent developments, as discussed below.

Listing Standards for Audit Committees. New listing standards by U.S. securities exchanges, when effective, will require the audit committee of a listed issuer to discuss earnings releases with management. In that case, it is reasonable to expect that an audit committee might request the auditor to provide some form of assurance that an earnings release containing quarterly or year-end earnings is fairly presented. Although there is no requirement that the audit committee discuss the earnings release with the auditor, an audit committee might believe it is necessary to do so to meet its oversight responsibility. That might be especially true for a year-end earnings release, since a change to an issuer's reported earnings during the period between the date of the earnings release and the date on which the 10-K is filed generally is perceived negatively by the marketplace as a type of restatement.

Issuance of PCAOB Auditing Standard No. 2. From a practical standpoint, the issuance of Auditing Standards No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (Auditing Standard No. 2), could have an effect on the date that the auditor has historically dated his or her report on the financial statements. Two provisions of Auditing Standard No. 2 interact to have this effect. First, Auditing Standard No. 2 provides clear direction to the auditor that the period-end financial reporting process is always a significant process, controls over which should be tested, as well as the timing of that testing. Specifically, AS No. 2 states—

The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date. For example, some controls over the period-end financial reporting process normally operate only after the "as of" date. Therefore, if controls over the December 31, 20X4 period-end financial reporting process operate in January 20X5, the auditor should test the control operating in January 20X5 to have sufficient evidence of operating effectiveness "as of" December 31, 20X4.

Second, Auditing Standard No. 2 states that the audit report on internal control over financial reporting should be dated the same as the audit report on the financial statements. Combined, these two provisions may have the effect on some engagements that the audit report on the financial statements is dated later than it was

in the past. If this is the case, it could highlight a disconnect between the date of the audit report and the auditor's responsibility for the issuer's earnings release.

Second Partner Review. The Board currently is developing a standard that sets forth an auditor's responsibility to provide a concurring or second partner review of the audited financial statements and related auditor's report to comply with Section 103 of the Sarbanes-Oxley Act. If the Board concludes that such a second partner review should be completed prior to the completion of fieldwork or prior to the issuance of the audit report, that situation might also act to, in many cases, encourage the auditor to date his or her audit report later than in the past. This too might cause the auditor to date his or her audit report as of a date other than the earnings release date.

Whatever the auditor's involvement with earnings releases, balancing investor's demands for relevant and reliable information needs to be considered. As the auditor takes on more responsibility for earnings releases, and presumably increases the reliability of the information communicated therein, delays may result in the release of that information to give the auditor the time necessary to complete any related procedures. Any associated delays may impair the relevance of earnings information.

For all of these reasons, issuers and other users who until now have enjoyed what they perceived to be an implied auditor imprimatur on their earnings releases when the audit report bears the same date as the date of the earnings release may not see those dates aligned as often in the future. Accordingly, they might now begin to see the need for an auditor to provide explicit assurances on the fair presentation of information contained in an issuer's earnings release.

Discussion Questions –

6. Do auditors expect that the date of their audit reports on the financial statements and internal control over financial reporting will frequently be after the issuer's earnings release date? How will issuers react to a later audit report date—will they continue to release earnings on the same date, or will they delay earnings releases? How will investors react to an earnings release date that isn't the same as the date of the auditor's report?
7. Should an auditor have any responsibility for an issuer's earnings release? If so, what procedures should the auditor be required to perform in connection with the earnings release? Would the benefits exceed the costs of such a responsibility? (Note: Whether the auditor should have a responsibility for communicating to an audit committee his or her views about the fair presentation of an issuer's earnings release will be considered under Agenda Item 12, "Communications and Relations with Audit Committees".)

8. How might those responsibilities differ for a fourth quarter earnings release (close to the completion of the audit of the financial statements) versus the other three quarters (close to the completion of the auditor's review under SAS No. 100)?
9. What form should the auditor's communication take, and how would such auditor responsibilities set by the Board need to be coordinated with requirements of issuers to be set by the SEC? For example, it would be up to the SEC to decide if an issuer should be required to attach some form of auditor's report or other disclosure about the auditor's involvement, or possible lack of involvement, to the Form 8-K containing the earnings release.
10. If the auditor is not required to be involved in the earnings release, should there be mandatory information in the release that it has not been subjected to independent audit?
11. How should the Board prioritize this project in light of other projects currently on its standards-setting agenda?