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The Proposed Expansion in Auditors Responsibilities

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ABSTRACT

In recent years, there have been several notable corporate failures. This has raised questions regarding the auditing process as well as the adequacy of the auditing report. Further, the debate or public misunderstanding of the auditor's role also continues to raise questions regarding how the auditor's report of publicly held companies can be more relevant and informative. Since the auditor's report is the primary means by which the auditor communicates information regarding the audit of the financial statements to investors, creditors and other financial statement users, there is a public demand for more relevant and detailed information from auditors in their auditing reports. In response to the public's outcry, the Public Company Accounting Oversight Board (PCAOB) is re-proposing a new auditor reporting standard, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion." The PCAOB contends that the goal of this proposed revised Standard is among other initiatives, to enhance the form and content of the Auditors report to make it more relevant and informative to investors and other financial statement users. To this end, the auditor's report would contain a significant amount of detailed information about critical, complex, challenging and subjective audit-specific matters as they relate to the relevant financial statement accounts and disclosures.

In this paper, we discuss the current role of auditors as depicted in relation to audit risk, materiality and reliance on management's assertions in light of Generally Accepted Auditing Standards (GAAS). Further, we discuss the implications of the PCAOB's re-proposal with the focus on how this revised standard may change or perhaps expand the auditors reporting responsibilities.

Keywords: *PCAOB; critical audit matters (CAMs); auditor responsibilities; fraud; ethics; audit failure; expectations gap; audit procedures; risk; materiality.*

INTRODUCTION

The significant amount of notable corporate failures has raised the question of the adequacy of auditors and the auditing process as well as the relevance of the auditing report. As top accounting firms continue to be sued over their role in providing an opinion on the reliability of financial statements, the auditor's responsibility and ability to detect errors and irregularities will continue to be questioned. While the responsibility to detect and prevent fraud and material misstatements does not reside solely with the auditor, the auditing process is vulnerable from legal attacks which will continue to challenge the auditors' professionalism. There has been a public outcry from investors, creditors and other financial statement users for more relevant and informative audit reports. Hence, there is greater demand for more specifics about the material information obtained during the audit process and the related audit procedures utilized to arrive at the auditor's opinion. Therefore, there is a demand for greater transparency of the audit procedures. The goal is to increase the report's "relevance and usefulness to investors and other financial statement users" (Cohn, 2013,1). To address the concern, the Public Company

Accounting Oversight Board (PCAOB) has again released a proposal (No. 2016-003) for a new auditor reporting standard, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion." The PCAOB contends that the goal of this proposed revised Standard is among other initiatives, to enhance the form and content of the Auditors report to make it more relevant and informative to investors and other financial statement users. To this end, the auditor's report would contain a significant amount of detailed information about critical, complex, challenging and subjective audit-specific information as they relate to the relevant financial statement accounts and disclosures. It is clear that this new standard will greatly increase the auditors' responsibilities and will undoubtedly become more expensive than ever for auditors to provide investors, creditors and other financial statement users with the assurance that financial statements are free of material misstatements.

The financial crisis of 2008 and the use of aggressive accounting techniques by Corporations such as Enron called into question the responsibility of auditors as well as the auditors' report. We discuss the role of auditors as depicted in relation to audit risk, materiality and reliance on management's assertions in light of Generally Accepted Auditing Standards (GAAS). We explore the possible defenses that are available to auditors when an incorrect audit report has been issued. We also consider the possible impact of the proposed PCAOBs standard on the increased responsibilities of auditors. Finally, we examine potential increased costs and other unintended consequences.

BACKGROUND ON THE AUDITORS REPORT

The global environment has increased in its complexity and the reporting frameworks have evolved. Further, the form and content of the auditor's report is undergoing change globally. "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", i.e. unqualified/qualified (PCAOB, 2016). The common theme is that information about audit-specific matters should be communicated in the auditor's report.

Despite all of the changes made by standard setters around the globe, the U.S. Standard Unqualified Auditor's Report that has been in existence since the 1940's and has remained unchanged. Over the years, attempts have been made to revise the auditor's report. In 2010, the "PCAOB started its standard-setting project on the auditor's reporting model….with outreach to different stakeholders, including investors, financial statement preparers, and auditors" (PCAOB, 2016). Additional changes were also discussed at various meetings in 2011, 2012 of the Board's Standard Advisory Group (SAG) and comments were solicited on the potential changes to the auditor's report. It was suggested that expanded auditor reporting would have been helpful before the 2008 financial crisis (page 6). After consideration of public comments, a proposal was made in 2013 to improve the auditors' report by making it more informative and relevant to financial statement users. However, not all concerned were in agreement with the nature and extent of the proposed changes. In 2014, a public meeting was held to obtain further input from a diverse group, such as financial statement users, preparers, audit committee members, authors, and others. This was followed by various meeting of the PCAOB's SAG. This led to the re-proposal of the auditor's reporting standard in the PCAOB's release No. 2016-003 on May 11, 2016. This re-proposal would retain the pass/fail opinion of the existing auditors' report but would make significant changes to the existing auditor's report.

INFORMATION ASYMMETRY

The primary means by which the auditor communicates information regarding the audit of the financial statements to investors, creditors and other users of the financial statements is through the auditor's report. However, the information contained in the auditor's report is limited. Thus, the "how" "what" and "why" of the reporting process and how the report was generated is not disclosed to the public.

"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 information is not known to investors" (PCAOB, 2016). Nevertheless, the current form of the auditors' report does not communicate these matters to the public. Hence, the corporation and auditors possess more or better information than the financial statement users. This imbalance is referred to as information asymmetry. The PCAOB asserts that the re-proposed standard is an attempt to address this imbalance of information.

COMPONENTS OF THE PCAOB'S RE-PROPOSAL

Following on the heels of weak financial markets and investor uncertainty of the late 1990's, a host of notable corporate failures, such as Enron in 2001 followed by, WorldCom, and others brought into question the relevance and reliability of the auditors' report and the effectiveness of the financial statement audits. These events created a credibility crisis for the accounting profession which was exacerbated by the conviction of the Big Five Accounting firm, Arthur Andersen on charges of destruction of documents. Despite the later reversal of the Andersen conviction, questions regarding management's ethics and the public accounting professions credibility were front and center in the public's mind. Thus, the damage had been done. In a swift response, Congress enacted the Sarbanes Oxley Act of 2002 (SOX). The aim of the Act was to restore investors' confidence in the financial system. It contained a set of reforms that toughened penalties for corporate fraud and restricted the type of work that CPAs could perform for public audit clients. The Act also created the PCAOB with a mandate to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports (Section 101(a) of Sarbanes Oxley Act of 2002). The PCAOB has "broad powers to develop and enforce standards for public accounting firms that audit companies that issue securities with the SEC" (Whittington & Pany, 2015).

The re-proposed standard that contains the new auditing report is the PCAOB's attempt to make the auditors' report more relevant and informative to investors and other financial statement users. It would retain the pass/fail opinion format but would make significant changes to the existing auditor's report. A major component of the re-proposal is to communicate **critical audit matters (CAMs)** that arise during an audit.

Components of the proposed standard regarding Critical Audit Matters (CAMs) are as follows:

1. A CAM 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. (PCAOB, 2016).
2. In making the determination of a CAM, the auditor would take into account factors specific to the audit, including:
   - Auditor's assessment of the risks of material misstatements;
   - Degree of audit subjectivity in applying 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;
   - The degree of auditor judgement or estimation by management, including estimates with significant measurement uncertainty;
   - The nature and timing of significant unusual transaction and the extent of related audit effort and judgments;
   - The nature of audit evidence obtained regarding the matter.
3. Communication of each CAM would include:
   a) Identifying the critical audit matter;
   b) Describing the principal considerations that led the auditor to determining that the matter is a CAM;
   c) Describe how it was addressed in the audit;
   d) Reference made to the relevant financial statement accounts and disclosures.
4. Documentation of the CAM would include the basis for the auditor's determination of either each matter that both 1) was communicated or required to be communicated to the audit committee and 2) relates to the accounts or disclosures that are material to the financial statements involves especially challenging, subjective, or complex auditor judgment.

Essentially, CAMs would require the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit or state that the auditor determined that there were no critical audit matters.

The PCAOB proposed that the diagram shown in Figure 1 utilized in making a determination of the existence of a CAM as well as communication of such matters.

In addition to the above changes, the re-proposal will also include other changes to the Auditor's Report. These 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, or make the auditor's report easier to read. These would include, a statement regarding auditor independence, auditor tenure, addressees of the report; enhance certain standardized language in the auditor's report such as adding the phrase whether "due to error or fraud," instead of just "material misstatements" and also require the opinion to be the first section of the auditor's report (These changes are highlighted in the PCAOB's proposed audit report shown in Illustration 1 below):

CONCEPTUAL PERSPECTIVE ON THE ROLE OF AUDITORS

The accounting standards provided a great deal of guidelines on the nature, timing and extent of the work that should be done by a company and verified by the auditors regarding various aspects of the financial statements and auditors are required to follow the guidance in the preparation of their financial statements. Nevertheless, with respect to complex transactions, it is possible that the Standards may not be very clear.

Invariably, Corporations take advantage of any cloudiness that may exist in Accounting Standards. Further, they often use questionable accounting techniques in an effort to influence performance measurements. These factors present challenges to auditors. In light of this situation, it is important to discuss the role of auditors.

The auditor is independent and lends credibility to the financial statements that are prepared by management. To this end, the auditor is required to follow Generally Accepted Auditing Standards (GAAS) to evaluate audit evidence to determine the correspondence of the information contained in the financial statements to a set of predetermined agreed policies and accounting criteria and verify the reasonableness of the financial information. In other words, the auditor issues a report to indicate the degree of correspondence of the information and its reliability. To arrive at this opinion, the auditor conducts an examination of the company's financial statements as presented by the company's management. However, the design of the audit, including the nature, timing and extent of the audit work performed are dependent on several factors; namely, audit risk, materiality and the reliance on the management's assertions about the financial statements.

Audit Risk

Audit risk (AICPA, AU 312, 2010) is defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. To incorporate this risk that a material misstatement could be in the financial statements and not be detected by the auditor, the standard auditor's report states that the auditor provides only "reasonable assurance" (not absolute) that the financial statements do not contain material misstatements. Since it is impractical or in most instances impossible for the auditor to test or verify everything, many tests of transactions are performed on a sample basis. Hence, the auditor generally adjusts the extent and conduct of the audit work to achieve an acceptable level of audit risk. Nevertheless, the risk still remains that the auditor may conduct an audit in accordance with GAAS and still be wrong in the issuance of their opinion.

Materiality

Materiality (FASB, SFAC, No. 2, 1990) is defined as the magnitude of a material omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. Hence, the auditor assesses the impact of the misstatement on the decisions of the users. In light of this assessment, the auditor is required to adjust the nature, amount and timing of the audit procedures that they perform particularly with respect to CAMs.

Evidence Regarding Management's Assertions

The financial statements are the responsibility of management. To arrive at an audit opinion, the auditor is required to obtain evidence from management and evaluate the relevance and reliability of this evidence. This means that the auditor is required to determine whether the client followed GAAP and whether the information they obtained from management could be relied upon to faithfully represent the true picture of the company. In the performance of an audit, the auditor is required to follow GAAS as well as those standards issued by the PCAOB.

GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

Generally Accepted Auditing Standards were first enacted by the AICPA in 1947 and have been periodically modified over the years in response to the changes in the auditing environment. In 2002, following Enron and other scandals, these Standards were adopted by the PCAOB. These Auditing Standards have been divided into three categories. These are: a) Three (3) General Standards; b) Three (3) Standards of Field Work; and c) Four (4) Standards of Reporting (Whittington & Pany, 2015).

General Standards

1. The audit must be performed by a person or persons having adequate technical **training** and proficiency as an auditor.
2. The auditor must maintain **independence** in mental attitude in all matters relating to the assignment.
3. The auditor must exercise **due professional care** in the performance of the audit and in the preparation of the report.

These three general standards are primarily concerned with the auditor's qualifications and the quality of his (her) work. To perform a proper audit, the auditor must have the proper formal training, qualifications and experience, be objective and exercise due care. Furthermore, the auditor would be reasonably expected to maintain professional competencies in the member's area of practice by satisfying on-going continuing professional education. This implies that the auditor must keep abreast of the current accounting pronouncements as well as new developments in the business world that affects his/her clients and by extension the audits that he/she performs.

As a result of our rapidly changing global environment, there is always the risk that the auditor will encounter a new situation or a sophisticated instrument as well as new and innovative accounting techniques that have not been addressed in the traditional accounting environment or auditing regulations. Under these circumstances, it is also important that professional judgment be utilized in evaluating the appropriateness of the matter under consideration. It is clear that the PCAOB's re-proposal is an attempt to address this rapidly changing environment.

When a new accounting technique or a CAM is encountered, it is necessary for the Auditor to assess the materiality of the matter and its impact on the financial statements. This presents an increased audit risk since it is possible that the Auditor would mistakenly issue a clean (unqualified) audit opinion on the financial statements when they are in fact materially misstated. In these cases, it is imperative that additional training be undertaken by auditors to better understand any new techniques encountered and/or rely on independent professionals with the appropriate knowledge and expertise. Failing to possess adequate technical training and failing to use due professional care violates the first standard of GAAS.

Fieldwork Standards

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to fraud or error, and to design the nature, timing and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

To assess the extent of the required work with respect to the standard of field work, the auditor must assess any increased risk emanating from the use of new or sophisticated accounting techniques. They must also examine internal accounting controls and policies within the company. Essentially, the Auditor must gather sufficient appropriate evidence to render an Audit opinion.

Increased Risk for Critical Audit Matters (CAMs)

When CAMs are encountered, it is imperative that substantial additional work be undertaken by the auditor to gain assurance that the components of the financial statements are properly accounted for, classified, valued and analyzed to determine the impact of these transactions upon the financial statements, including the footnotes. If necessary, Auditors should expand their investigation and accumulate additional audit evidence. If CAMs are found, then the Auditor needs to apply more professional skepticism to their audit work. Any findings regarding the CAMs must be reported to senior management and the Audit Committee.

Standards of Reporting

The four standards of reporting require the auditor to consider various factors prior to the issuance of an audit report. These are: (1) whether the financial statements were prepared in accordance with GAAP; (2) whether the principles are consistently applied; (3) whether all informative disclosures have been made, and (4) the character of the auditor's work as well as the degree of responsibility the auditor is taking.

Appropriate Disclosures

Without question, material transactions need to be disclosed in the notes to the financial statements in order to provide relevant information needed for decision making. In this way, the financial statements should adequately portray the heightened risk emanating from any material transactions. Hence, prudent persons who rely on these financial statements would be in possession of all material disclosures.

IMPLICATIONS

Given several major studies examining how CAMs may impact the auditing profession, and financial reporting (Kachelmeier, 2016, 1), (Christensen, 2014), it is clear that there are major considerations that can be used to enhance the auditing process of companies in general. It is clear that the PCAOB proposal seems to be a positive step in the right direction. Nevertheless, the proposed Auditing Standard has many implications. Several of which are highlighted below:

1. The financial world is increasing in its complexity as new and innovative financial and other instruments are created. This implies that when a new situation is encountered or circumstances where the climate has changed, it is important that more audit work be undertaken and that an increased level of healthy skepticism be incorporated during the auditors work. It is also important that the audit risk be reevaluated, the staffing requirements be adjusted, the audit plan be revised and that the audit procedures are modified as necessary to ensure that the new circumstances are adequately considered.
2. A host of potentially risky products and situations are emerging. As a result, the auditing environment is also becoming more complex. It is more important than ever that auditors are mindful of the global environment in which they operate. To this end, it is imperative that auditors become totally familiar with the businesses in which their companies operate and adjust the nature, timing and extent of their auditing work accordingly.
3. It is clear that the public's expectation of the auditor's report is changing and may in fact, be increasing. The public is demanding more from auditors and their corresponding report issued on the financial statements. This gap between the public's expectations and the auditor's work must be bridged so that auditors and the companies as well as the public will be on the same page with respect to the assurances provided regarding the financial statements. Auditors must keep pace with the public's expectations. The PCAOB's re-proposed standard and related auditors' work is an attempt to bridge the gap and respond to the public's demands.
4. Accounting Standards will have to be constantly reviewed and adjusted to reflect the current environment so as to ensure the safety and soundness of the financial system. Accounting standards need to be more proactive rather than reactive.
5. The additional reporting requirements for CAMs as well as other requirements of the proposed revised auditor's report will indeed result in increased work and responsibilities for auditors. This will undoubtedly lead to increased audit fees. The additional information contained in the report may also lead to increased questions of auditors and management from financial statement readers.

FUTURE RESEARCH

The PCAOB's proposed standard for a revised Auditor's Report has raised numerous questions about the auditing profession. These questions have significant future implications and can lead to very rich future research. Several of these issues are delineated as follows:

1. New and innovative financial products are being created each day. What are the risks from these new financial products? How can these risks be evaluated from an auditing perspective prior to the products being used within the financial community? It is apparent that the proper identification of product risks ensures a thorough understanding of the products and how the products should be measured, reported, disclosed for auditing and accounting purposes.
2. In 2008, the subcommittee recommended that the auditing profession implement market-driven, dynamic curricula and content to improve training for accounting students. It is necessary to delineate the steps that have been taken by the auditing profession and assess whether these steps are effective. To this end, it is necessary to discuss and evaluate the effectiveness of recommendations from the Subcommittee on Human Capital to the Advisory Committee on the Auditing Profession.

CONCLUSION

The accounting and auditing profession received considerable scrutiny in light of the corporate failures and the financial crisis of 2008 and subsequent market volatility. As the global environment increases in its complexity, many new and innovative instruments and vehicles will be utilized by companies as they try to maintain their competitive advantage. To this end, investors, creditors and other financial statement users are demanding a more relevant and informative Auditor's report. In light of this demand and meeting its statutory mandate to protect the interests of investors and further the public interest, the PCAOB is proposing a revised audit report which is believed will be more informative, accurate and independent. The proposed PCAOB' audit report is intended to provide additional information particularly with respect to Critical Audit Matters encountered during the audit of their clients financial statements. The re-proposal will lead to increased responsibilities for auditors. Notwithstanding this, Auditors must remain ever mindful of their role and the reliance of the public on their audit reports and their opinions. To this end, their independence as well as the healthy skepticism of the auditor must be heightened. Additionally, the amount, nature and timing of the audit work must be adjusted to reflect the appropriate risk in each individual audit situation and appropriately reflected in the revised auditor's report.

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Appendix

Figure 1: Determining and Communicating Critical Audit Matters ("CAMs")

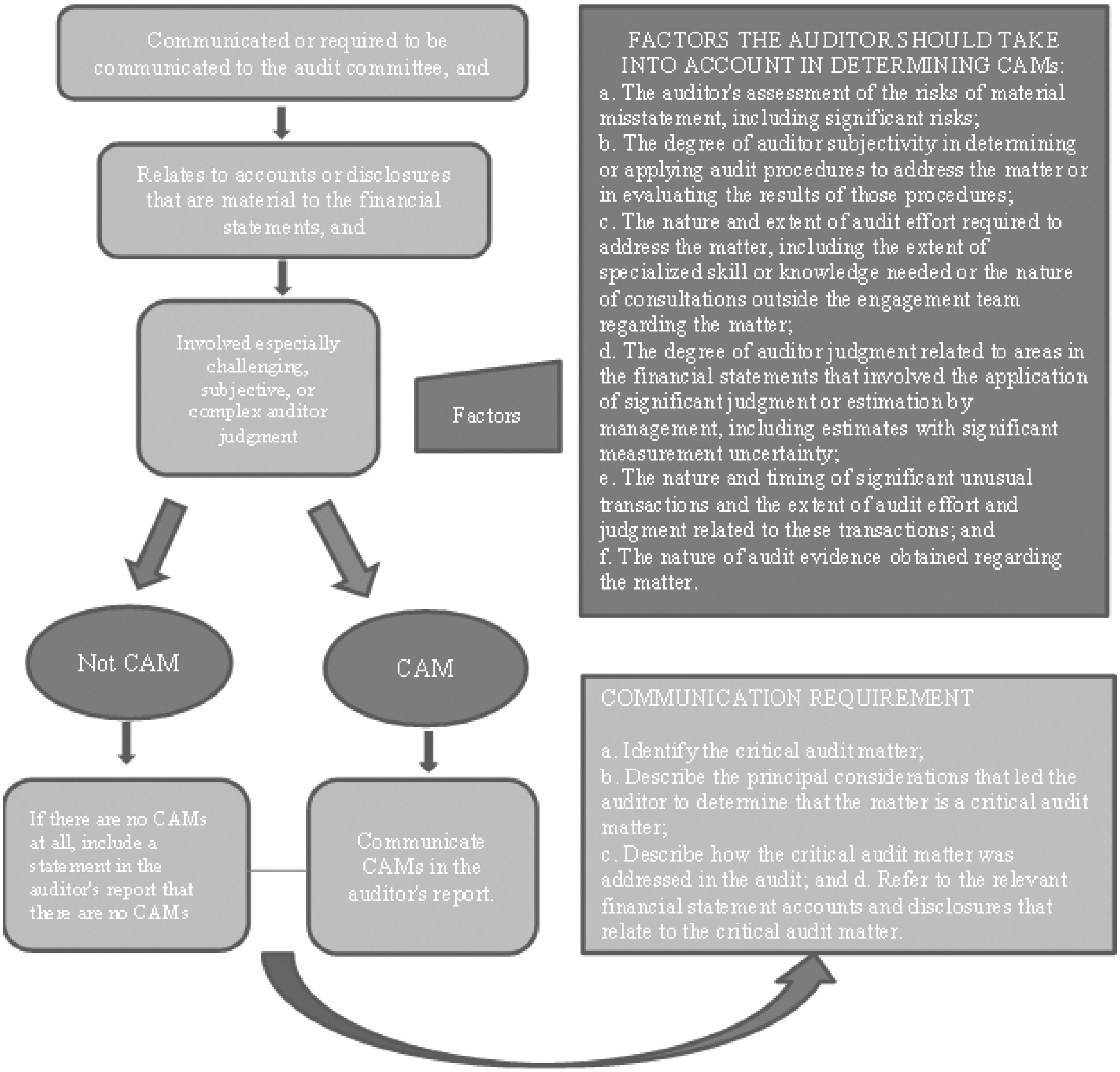

Illustration 1 – An Illustrative Auditor's Unqualified Report Including Critical Audit Matters

The following report is the proposed Auditors Opinion from the PCAOB. The proposed changes from the current auditors report are underlined.

"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 operations, 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 include 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 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. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide 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] Report" (PCAOB, Release No. 2016-003, May 11, 2016).