

October 30, 2017

## SEC Approves New PCAOB Auditor Reporting Standard

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### **New Standard Expands the Scope of the Auditor's Report and Requires Auditors to Identify and Discuss "Critical Audit Matters"**

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#### **SUMMARY**

On October 23, 2017, the U.S. Securities and Exchange Commission approved Auditing Standard No. 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments to its auditing standards in the form adopted by the Public Company Accounting Oversight Board in June 2017.<sup>1</sup> The new standard expands the scope of the auditor's report for certain public companies while retaining the "pass/fail" opinion of the existing auditor's report. Most notably, the new standard will require auditors to identify and discuss, in the audit report, "critical audit matters" (CAMs) that were addressed in the audit. SEC reporting companies and their audit committee should initiate a dialogue with their auditors, to the extent they have not already done so, to understand how their auditors expect to approach CAMs, what types of matters may merit this designation and how the auditors expect to address them in the audit report. The new standard will take effect (1) with respect to CAMs, for audits for fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other covered companies, and (2) with respect to all other provisions, for audits for fiscal years ending on or after December 15, 2017.

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#### **THE NEW STANDARD AND RELATED AMENDMENTS**

The new standard and related amendments approved by the SEC are set forth in the PCAOB's June 1, 2017 release, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*.<sup>2</sup> The new standard reflects the PCAOB's stated objective to enhance communication about the financial statement audit and make the

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auditor's report more informative and relevant to investors. In approving the proposal, the SEC addressed significant concerns raised by industry commenters related to CAMs and cited the steps taken by the PCAOB to limit the scope of what constitutes a CAM and clarify the process for identifying them. In particular, the SEC noted that the PCAOB limited CAMs to matters communicated or required to be communicated to the audit committee, added a materiality component to the CAM definition and narrowed the definition to cover only matters that involved especially challenging, subjective, or complex auditor judgement. SEC Chairman Jay Clayton acknowledged the concerns related to CAMs and urged all those involved in the implementation of the new standard, including the SEC and the PCAOB, to closely monitor these issues going forward in an effort to limit unintended consequences of the new standard, such as frivolous litigation, boilerplate statements, or antagonistic auditor-audit committee relationships.

The new standard requires changes to the substance of the auditor's report. The most prominent change is the required discussion of CAMs, which, under the new heading "Critical Audit Matters," requires the auditor to:

- identify each CAM,
- describe the principal considerations that led the auditor to determine that the matter is a CAM,
- describe how the CAM was addressed in the audit, and
- refer to the relevant financial statement accounts or disclosures that relate to the CAM.

In situations in which the auditor determines that there are no CAMs, the auditor will be required to include a statement to that effect. The PCAOB has indicated that it expects CAMs will likely be identified in areas that investors have indicated would be of particular interest to them, such as (1) significant management estimates and judgments made in preparing the financial statements; (2) areas of high financial statement and audit risk; (3) significant unusual transactions; and (4) other significant changes in the financial statements.

The new standard also revises the format and presentation of the auditor's report. The auditor's opinion will appear in the first section of the report under the heading "Opinion on the Financial Statements," and the basis for the auditor's opinion will appear in the second section of the report under the heading "Basis for Opinion." The new standard does not specify an order for the "Critical Audit Matters" section and the remaining sections of the auditor's report, which would include explanatory paragraphs, but does require titles for all sections to provide consistency and assist users in identifying the individual sections of the report. Finally, the new auditor's report must be addressed to the company's shareholders and board of directors or equivalents, with additional addressees permitted.

The new standard is considered by the PCAOB as analogous in many respects to the auditor reporting requirements established in recent years by several international regulators and standard setters, including the International Auditing and Assurance Standards Board (IAASB), the EU, and the UK

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Financial Reporting Council, all of which have expanded the auditor's report beyond a binary "pass/fail" model. Auditor reports prepared under these standards generally are much lengthier and include multiple pages of discussion regarding the audit approach, including a discussion of a number of key audit matters (or areas of focus, risk, or similar terminology), how they were addressed in the audit, and the primary procedures followed to address such matters, as well as standards of materiality considered by the auditors. The nature of the key audit matters discussed in published auditor's reports under these standards cover a range of topics, including taxation, contingent liabilities, impairment/asset valuation, and environmental obligations, among others. U.S. issuers trying to anticipate what their auditor's report may look like after implementation of the new standard may want to look at auditor's reports issued for issuers subject to IAASB, EU or UK audit requirements.

The SEC acknowledged that the enhanced communications required of auditors under the new standard represents a significant change in practice for auditors, companies, and audit committees, and noted the importance of monitoring the implementation of the new standard. The SEC indicated that post-implementation review of the new standard by the PCAOB should assess the effectiveness of the new standard using economic analysis tools and unintended consequences reports as key components of the evaluation of the new standard. Depending on the early-stage findings of the post-implementation review, the PCAOB may be called upon to make changes to the new standard, including to the effective date for companies not yet subject to the CAM requirements.

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### IMPLICATIONS

The new standard confers substantial discretion upon the auditor in identifying CAMs and then in describing those matters in the auditor's report. The new auditor's report will reflect the auditor's perspective on CAMs, which may be inherently different from management's or the audit committee's perspective. Some portion of these matters are likely to arise in contexts where the company is already addressing sensitive or complex disclosure issues, but the interaction between CAMs and the company's disclosure will be a critical consideration for management and audit committees. It is likely that, in certain cases, companies will wish to revise or supplement their own disclosure in light of the auditor's discussion of CAMs in order to ensure that the totality of the disclosure reflects an accurate and complete picture. As such, companies and their audit committees should initiate a dialogue with their auditors now in order to better understand various implementation points, including:

- how the auditor may approach the CAM requirement in the context of their particular company;
- what matters may, in the auditors' view, merit this designation; and
- what sort of disclosure the auditor would anticipate making in its audit report.

While the auditor can only make actual determinations on CAMs while undertaking the audit, it might be beneficial for management and audit committees to review possible CAMs with their auditors on a hypothetical basis, relative to a prior year's audit or as part of a pre-effective date audit, discussing what

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might have been identified as CAMs and how the auditor might have addressed them. Those discussions could lead to revisions or supplements to disclosures in light of those potential CAMs. Issuers should also expect that underwriters will begin to discuss CAMs with issuers and their auditors as part of their due diligence procedures.

In addition, the adopted standard requires that the auditor's report disclose the auditor's tenure as a company's independent auditor. In recent years, the impact of auditor tenure on the determination of auditor independence has been increasingly scrutinized by investors. Therefore, companies with long-tenured auditors may wish to articulate and disclose to the public the benefits they see in those arrangements and the measures in place to safeguard auditor independence that the audit committee considers when deciding whether to reappoint the company's auditor.

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### ENDNOTES

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- <sup>1</sup> SEC Release No. 34-81916, *Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures from Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards*, available at <https://www.sec.gov/rules/pcaob/2017/34-81916.pdf>. For a discussion of the PCAOB's adoption of the new standard and related amendments, please see our publication, dated June 5, 2017, entitled [PCAOB Adopts New Auditor Reporting Standard and Other Amendments Relating to the Auditor's Report](#).
- <sup>2</sup> PCAOB Release No. 2017-001, *Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, available at <https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf>.

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