

June 5, 2017

## Auditor's Reports

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### PCAOB Adopts New Auditor Reporting Standard and Other Amendments Relating to the Auditor's Report

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#### SUMMARY

The Public Company Accounting Oversight Board has adopted 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 that are intended to make the auditor's report more informative and relevant to investors and other financial statement users by requiring new information about the audit. Most notably, the new standard, which was adopted substantially in the form repropounded in May 2016, adds a requirement for the auditor to identify and discuss, in the audit report, "critical audit matters" that were addressed in the audit. The PCAOB anticipates that, subject to Securities and Exchange Commission approval, the new standard will take effect (1) with respect to critical audit matters, 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. SEC-reporting companies and their audit committees should initiate a dialogue with their auditors to understand how their auditors expect to approach critical audit matters and should consider whether additional company disclosure may be necessary or desirable in light of the new standard, including prior to the effective date for disclosure of critical audit matters in auditor's reports.

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#### BACKGROUND

The adoption of the new standard and related amendments culminates a PCAOB process that has extended more than six years. In 2011, the PCAOB issued a concept release on the auditor's report, and in 2013, the Board issued a proposed standard that incorporated a critical audit matters disclosure requirement. In response to comments received and discussions held during the public comment period,

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the Board repropose the standard for further public comment in May 2016 (the “reproposed standard”).<sup>1</sup> The reproposed standard modified the previous proposal by refining the critical audit matters disclosure requirement and dropping a previously proposed new standard governing the responsibilities of auditors with respect to information outside the audited financial statements in a company’s annual report. On June 1, 2017, the reproposed standard and related amendments were adopted by the Board.

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### THE ADOPTED STANDARD AND RELATED AMENDMENTS

The new standard and related amendments are set forth in the PCAOB’s June 1, 2017 release (the “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>, and according to the release, are intended to respond to the strong interest of investors for enhanced communication about the financial statement audit without imposing requirements beyond the auditor’s expertise or mandate. The PCAOB considers the requirements of the adopted standard 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, the EU, and the UK Financial Reporting Council, all of which have expanded the auditor’s report beyond a binary “pass/fail” model.

The new standard retains the pass/fail opinion of the existing auditor’s report but makes other significant changes to the auditor’s report, which are described in detail below. In addition to the new standard, the PCAOB also adopted amendments to several of its existing auditing standards solely to conform to the new standard.

#### Critical Audit Matters

A requirement to disclose critical audit matters is the most prominent feature of the new standard. The PCAOB noted that the disclosure of critical audit matters will “inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgement, and how the auditor addressed these matters.” According to the release, the Board anticipates that critical audit matters will likely be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements.

As described in the adopted standard, the requirement to disclose critical audit matters dictates that an auditor must:

- identify a critical audit matter;
- describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;

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- describe how the critical audit matter was addressed in the audit; and
- refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.

Like its definition under the repropose standard, under the adopted standard, a critical audit matter is defined as any matter 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. The PCAOB recognizes that what constitutes a critical audit matter is inevitably a principles-based, audit-specific determination. The adopted standard therefore does not prescribe a list of critical audit matters, but simply provides factors to be taken into account, individually or in concert, to determine whether a matter constitutes a critical audit matter. These factors include, but are not limited to:

- the auditor's assessment of the risks of material misstatement (including significant risks);
- the degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management (including estimates with significant measurement uncertainty);
- the nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- the degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those 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 regarding the matter); and
- the nature of audit evidence obtained regarding the matter.

The adopted standard, like the repropose standard, does not mandate a particular way of describing how each critical audit matter was addressed in the audit. However, in a note in the adopted standard, the PCAOB, to "clarify the Board's expectations while providing flexibility," has suggested that an auditor may describe:

- the auditor's response or approach that was most relevant to the matter;
- a brief overview of the procedures performed;
- an indication of the outcome of the auditor's procedures; and
- key observations with respect to the matter, or some combination of these elements.

The PCAOB recognizes that the description of how the critical audit matter was addressed in the audit will require judgment, and advises that auditors bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company's financial statements that will be useful to investors.

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The adopted standard states that auditors are expected to convey to investors the principal considerations and how the auditor addressed the matter without including previously undisclosed information, to the extent they are able to do so. However, the adopted standard provides that even when management has not disclosed information, “the auditor is not constrained from providing such information if it is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.”

The PCAOB expects that most audit reports will include at least one critical audit matter. However, the Board recognizes that there may be circumstances in which the auditor determines there are no critical audit matters, in which case the auditor’s report must contain a statement to that effect.

Under the adopted standard, the critical audit matters requirement does not apply to audits of emerging growth companies (as defined under the Jumpstart Our Business Startups Act). The adopted standard also does not apply to audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies (other than business development companies), and employee stock purchase, savings and similar plans. Auditors of these entities may choose to include critical audit matters in the auditor’s report voluntarily.

### **Additional Changes to the Auditor’s Report**

The new standard also includes a number of other changes to the auditor’s report that, according to the release, are primarily intended by the PCAOB to clarify the auditor’s role and responsibilities related to the audit, provide additional information about the auditor, and make the auditor’s report easier to read, such as:

- the auditor’s report must include a statement disclosing the year in which the auditor began serving consecutively as the company’s auditor;
- the auditor’s report must include a statement that the auditor is required to be independent;
- certain standardized language in the auditor’s report has been changed (including adding the phrase, “whether due to error or fraud,”) when describing the auditor’s responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements;
- the auditor’s opinion will appear in the first section of the auditor’s report and section titles have been added; and
- the auditor’s report will be addressed to the company’s shareholders and board of directors (or equivalents).

These requirements apply to all audits conducted under PCAOB standards, including auditor’s reports as to which the critical audit matters requirement does not apply.

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## **EFFECTIVE DATES**

The new standard and related amendments are subject to SEC approval. Subject to this approval, the PCAOB is adopting a phased approach to effective dates for the new requirements to provide accounting

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firms, companies, and audit committees additional time to prepare for implementation of the critical audit matter requirements. The PCAOB anticipates that the new standard and amendments will take effect as follows:

- all provisions other than those related to critical audit matters will take effect for audits for fiscal years ending on or after December 15, 2017; and
- provisions related to critical audit matters will take effect 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 companies to which the requirements apply.

Auditors may elect to comply before the effective date, at any point after SEC approval of the new standard and amendments.

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### IMPLICATIONS

The new standard confers substantial discretion upon the auditor in identifying critical audit matters and then in describing those matters in the auditor's report. The new auditor's report will reflect the auditor's perspective on critical audit matters, 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 critical audit matters 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 disclosures in light of the auditor's discussion of critical audit matters 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 critical audit matters 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 critical audit matters while undertaking the audit, it might be beneficial for managements and audit committees to review possible critical audit matters 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 might have been identified as critical audit matters and how the auditor might have addressed them. Those discussions could lead to revisions or supplements to disclosures in light of those potential critical audit matters. Issuers should also expect that underwriters will begin to discuss critical audit matters with issuers and their auditors as part of their due diligence.

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

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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 of long-tenured auditors and the measures in place that serve to safeguard auditor independence that the audit committee considers when deciding whether to reappoint its auditor.

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### ENDNOTES

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- <sup>1</sup> For a discussion of the repropose standard, please see our publication, dated May 25, 2016, entitled [Audit Reports “PCAOB Releases Reproposal of Amendments to Its Audit Report Standard.”](#)
- <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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