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PCAOB Revises the Auditor's Report

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Last week, the Public Company Accounting Oversight Board (PCAOB) adopted a new auditor reporting standard – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* – that is intended to make the auditor's report more relevant to investors by requiring more information about the audit. The standard retains the pass/fail opinion options of the existing auditor's report, but makes significant changes to it by requiring the communication of critical audit matters (CAMs) to inform investors and other financial statement users of matters arising from the audit process that necessitated especially challenging, subjective or complex auditor judgment, and how the auditor responded to those matters in coming to the overall conclusion on the audit. Other, less significant changes to the auditor's report were made, which are enumerated below.

Subject to approval by the U.S. Securities and Exchange Commission (SEC), the final standard and amendments will take effect as follows:

- All provisions other than those related to CAMs (see below) will take effect for audits for fiscal years ending on or after December 15, 2017; and,
- Provisions related to CAMs 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.

The PCAOB allows auditors to comply with the standard before the effective date, at any point after SEC approval of the final standard.

The new standard only applies to audits conducted under PCAOB standards. In addition, it specifically concludes that the communication of CAMs is *not* required for audits of brokers and dealers; investment companies other than business development companies; employee stock purchase, savings and similar plans; and emerging growth companies. The new standard is available at https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf.

Background

The PCAOB’s rulemaking process in generating the new standard has unfolded over a long period of time. In 2008, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession issued its final report recommending, among other things, that the PCAOB "consider improvements to the auditor's standard reporting model." In 2010 and 2011, the PCAOB staff conducted outreach to investors, auditors, preparers of financial statements, audit committee members and other interested parties to seek their views on potential changes to the auditor's report.

In 2011, the PCAOB issued a concept release and held a public meeting to obtain insight from a diverse group of investors and other financial statement users, preparers of financial statements, audit committee members and auditors on the alternatives presented in the concept release. In 2013, an enhancement of the auditor's reporting model was proposed with an objective to communicate CAMs in a new section in the auditor’s report to make the audit process more transparent. The PCAOB received almost 250 comment letters to its proposal and held a public meeting in 2014 to discuss the proposal and comments received and obtain further input. Due to the preponderance of concerns, that proposed standard was not issued.

Just over a year ago, the PCAOB once again proposed for public comment enhancements to the auditor’s report to provide information on CAMs. The reproposal received 88 comment letters. In reproposing a new standard, the PCAOB sent a clear message that it was intent on furthering its mission to make audit reports on the financial statements of public companies more informative.

The Focus on Critical Audit Matters

The new standard requires the auditor to communicate, in the auditor's report, any CAMs arising from the current period's audit of the financial statements, or state that the auditor determined that there were no CAMs. 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) involves especially challenging, subjective or complex auditor judgment.

When determining whether a matter involves “especially challenging, subjective or complex auditor judgment,” the auditor takes into account certain factors including, but 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.

In the audit report itself, the communication of each CAM must include identification of the CAM, description of the principal considerations that led the auditor to determine that the matter was a CAM, description of how the CAM was addressed in the audit, and reference to the relevant financial statement accounts or disclosures. There are also important documentation considerations related to CAMs. For each matter arising from the audit of the financial statements that (a) was communicated or required to be communicated to the audit committee, and (b) relates to accounts or disclosures that are material to the financial statements, the auditor must document whether or not the matter was determined to be a CAM and the basis for such determination. The distinguishing factor in differentiating matters that are a CAM and matters that aren’t is whether they involve especially challenging, subjective or complex auditor judgment during the audit process.

Additional Changes to the Auditor’s Report

The final standard also includes other changes to the auditor's report that are primarily intended 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. These changes are:

- ***Auditor tenure –*** The report must include a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;

- ***Independence* –** The report must include a statement that the auditor is required to be independent;
- ***Addressees* –** The report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees also are permitted);
- ***Enhancements to the basic report language* –** 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; and
- ***Standardized form of the auditor's report* –** The opinion will appear in the first section of the auditor's report and section titles have been added to guide the reader.

An illustrative auditor's unqualified report is included in Appendix B of the new standard. As noted earlier, the above changes must be implemented for audits covering fiscal years ending on or after December 15, 2017; therefore, their implementation precedes the required timetable for incorporating CAMs.

Unintended Consequences

The PCAOB states that the results of implementation will be monitored for any unintended consequences. The board anticipates additional costs related to increased time needed to prepare and review auditor's reports, including discussions with management and audit committees, as well as legal costs to review the information provided in the CAMs. In addition, auditors may choose to perform more audit procedures related to areas reported as CAMs (even though the performance requirements in those areas are unchanged), with the resulting cost implications for both auditors and companies. The question is, how much?

One consequence to watch for is whether auditors will require disclosure of original information in articulating the CAMs encountered during the audit. Some commenters pointed out during the reproposal public comment period that limitations of the auditor's knowledge and expertise, potential liability implications, and friction in the relationship with the company may become influencing factors that would "discourage auditors from going beyond management disclosures." To this point, the PCAOB stated:

> While auditor reporting of original information is not prohibited, it is limited to areas uniquely within the perspective of the auditor: describing the principal considerations

> that led the auditor to determine that the matter is a [CAM] and how the matter was addressed in the audit. The objective of [CAMs] – helping investors to focus on identified areas of the audit and understand how the auditor addressed them – may not be accomplished if the auditor is prohibited from providing such information. Moreover, prohibiting the auditor from providing such information could make [CAM] communications incomplete in a way that could be confusing to or misunderstood by investors

No doubt, this will place companies and their auditors on a collision course in deciding how much is enough. Some commenters claimed the communication of CAMs would give auditors leverage to encourage disclosure of additional information by management. While some may see such a development as beneficial, others aren't as sure, raising concerns of significant costs, disclosure of confidential or competitively sensitive information, and potentially misleading or incomplete information.

Summary

Needless to say, this standard is a significant change in practice that could alter the relationship dynamics between the auditor and the audit client – both management and the audit committee. From the auditor's perspective, it will present an opportunity to offer more insight to investors, regulators and the plaintiff bar as to the underlying audit issues. It is reasonable to expect the accounting firms to determine specific areas by industry that are most likely to involve especially challenging, subjective or complex auditor judgment and are, therefore, likely candidates for CAM treatment. The objective would be to insulate audit partners from the difficulties of making such determinations on a case-by-case basis.

Another point to watch for is whether any of the audit firms elect to implement this standard early. Given the lead time the firms leave themselves for implementation purposes, it would be wise for management and the audit committee to inquire of the auditor now, rather than later, as to the areas that might qualify as a CAM and what steps the company might take to make it easier for the auditor to exercise judgment in those areas. Such discussions may lead to worthwhile improvements in the financial reporting process.

It also will be interesting to see if the items reported as CAMs are used by the SEC as a guide in developing questions posed in comment letters to registrants, and how that dynamic, if manifested, impacts the attorney-auditor-client interactions in drafting and issuing securities filings. Likewise, the PCAOB may compile CAM data as a source of input for determining the scope of its inspections process.

Still another question is how practice will evolve whenever the auditor communicates with management and the audit committee. PCAOB inspections could create subtle pressure on auditors to "say something" in the audit report whenever a matter is communicated. We believe it is vital to the auditor-client relationship that auditors be able to distinguish between CAMs and other matters. Inability to do so with clarity could result in a chilling effect on the relationship and communications. Accordingly, PCAOB monitoring is important as the new standard could impact both the matters communicated by auditors to management and the audit committee, as well as the manner in which those matters are communicated.

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