PCAOB FLASH REPORT

PCAOB Reproposes Standard Requiring Auditor's Report to Address Critical Audit Matters

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In 2013, the Public Company Accounting Standards Board (PCAOB) proposed a new auditing standard to enhance the auditor's reporting model. One of the objectives of the proposed standard was to communicate critical audit matters in the auditor's report to make the report more informative, thereby increasing its relevance and usefulness to investors and other financial statement users. The proposal to include a new section in which critical audit matters specific to an audit would be communicated was intended to make the audit process more transparent. The PCAOB received almost 250 comment letters to its proposal. In 2014, the board held a public roundtable to discuss the proposed standard and comments received and obtain further input. Due to the preponderance of overwhelming concerns, the proposed standard was not issued.

Earlier this month, the PCAOB once again proposed for public comment enhancements to the auditor's report to provide information on critical audit matters. In reproposing a new standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, the PCAOB has sent a clear message that it is not giving up on its quest to make audit reports on the financial statements of public companies more informative.

The revised proposal would generally apply to audits conducted under PCAOB standards, except that, unlike the 2013 proposal, the requirements regarding critical audit matters would not apply to audits of brokers and dealers (reporting under the Securities Exchange Act of 1934 Rule 17a-5); investment companies other than business development companies; and employee stock purchase, savings and similar plans. The reproposed standard is available at https://pcaobus.org//Rulemaking/Docket034/Release-2016-003-ARM.pdf. The public comment period expires on August 15, 2016.

Why Was the 2013 Proposal Tabled?

In feedback received through comment letters and public meetings, a number of concerns were raised regard the PCAOB's original proposal. While many respondents supported the PCAOB's objective to improve the relevance of the auditor's report, issues were raised regarding the practical application and potential consequences of the standard if it were issued as proposed.

The issues raised posed conflicting pressures on the proposal. To illustrate, there was the concern over putting the auditor in a position to comment on matters that the company was not required to disclose, e.g., significant control deficiencies, the possibility of an illegal act and certain matters related to going concern. That said, redundant communications of critical audit matters pertaining to information already disclosed in the financial statements might prove counterproductive. If the auditor report includes disclosures of critical audit matters already provided in management's disclosures, the value provided to investors will be limited. Furthermore, if reporting of critical audit matters resulted in more boilerplate or information overload resulting from seemingly endless descriptions of critical audit matters, the PCAOB's purpose would be compromised.

Questions were also raised regarding the impact of the proposed reporting enhancements on (1) the timetable to complete the audit process and meet the issuer's filing deadlines with the Securities and Exchange Commission (SEC), (2) communications among auditors, management and audit committees, and (3) audit fees. Finally, many commenters observed that the current "pass/fail" model had served the marketplace well over the years.

How Is the 2016 Proposal Different?

Given the comments received and the results of additional feedback from its various outreach activities since tabling the 2013 proposal, the PCAOB has modified its proposed enhancement requirements in several ways. For example, the reproposed standard limits the source of potential critical audit matters to those required to be communicated to the audit committee and adds a materiality component to the definition of a "critical audit matter." Specifically, a critical audit matter is any matter that was communicated or required to be communicated to the audit committee <u>and</u> relates to accounts or disclosures that are material to the financial statements <u>and</u> involved especially challenging, subjective or complex auditor judgment.

By narrowing the scope of a critical audit matter to only those matters that involve especially challenging, subjective or complex auditor judgment, the PCAOB believes it has addressed the concerns raised on the 2013 proposal while at the same time providing important additional information to investors. According to PCAOB Chairman James R. Doty in the board's accompanying press release:

> In today's complex economy, and particularly in light of lessons learned after the financial crisis, investors want a better understanding of the judgments that go into an audit opinion. This proposal delivers on the intention of Congress to further the public interest in the preparation of more informative audit reports for public investors.

In addition to redefining the scope and reach of a critical audit matter, the PCAOB also narrowed the nature and extent of the documentation required when disclosing a critical audit matter. The auditor's report would require communication of any critical audit matters arising from the audit of the current period's financial statements. For a given critical audit matter, the auditor would be required to:

- Describe the principal considerations that led to the determination that the matter is a critical audit matter;
- Describe how it was addressed in the audit; and
- Refer to the relevant financial statement accounts and disclosures.

Consistent with the definition of a critical audit matter, the auditor would document the basis for determining each matter, i.e., that each matter (1) was communicated or required to be communicated to the audit committee; (2) relates to accounts or disclosures that are material to the financial statements; and (3) involved especially challenging, subjective or complex auditor judgment. If there are no critical audit matters, the auditor would so state that point in the auditor's report.

In addition, the reproposal does not include the provision for a new auditing standard regarding the auditor's responsibilities for other information outside the financial statements. Most importantly, it retains the pass/fail model in the existing auditor's report.

Factors to Consider

In determining whether a matter involved "especially challenging, subjective or complex auditor judgment," the reproposed standard lists several factors for the auditor to take into account, either alone or in combination:

- The auditor's assessment of the risks of material misstatement, including significant risks;
- The degree of auditor subjectivity in determining or 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;
- 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; and
- The nature of audit evidence obtained regarding the matter.

Essentially, these factors relate to significant audit risks.

Other Requirements

The reproposed standard would include additional changes to the existing auditor's report, requiring specific language:

- ***With respect to independence*** – A statement would be included in the report about the requirement for the auditor to be independent with respect to the company in accordance with the securities laws and the applicable rules and regulations of the SEC and the PCAOB.
- ***To clarify the auditor's responsibilities*** – When describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, the report would state "whether due to error or fraud."
- ***Regarding tenure –*** A statement would be added in the auditor's report about how long it has been the auditor for the company.

Finally, the standardized form of the auditor's report would require the auditor's opinion to be the first section of the auditor's report and would require section titles to guide the reader.

Summary

The PCAOB's objective is clear: to enhance the relevance of the auditor's report to investors. Few parties disagree with this objective, but like everything else, the devil is in the details. Having been sent back to the drawing board after floating its 2013 proposal, the PCAOB has now emerged with an updated proposal that signifies both its persistence and determination to achieve its objective. However, achieving this objective with the right balance is illusive. The feedback during the comment period will be interesting to follow and certainly worth keeping an eye on. Will there be commentary on possible unintended consequences, e.g., on the relationship between the auditor and the audit client, the auditor's exposure to the plaintiff bar, the issuer's exposure to class action litigation, the potential for pressure on auditors to "say something,” the possibility of addressing complex audit areas unique to an industry in a boilerplate manner, among other things? Only time will tell.

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