Client Alert

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PCAOB Adoption of Enhanced Auditor's Reporting Model

Summary

On June 1, 2017, the Public Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which the PCAOB believes will increase the relevance and utility of auditors' reports by including additional information regarding the audit process, and other disclosures. Most significantly, the new standard requires inclusion in the audit report of a discussion of critical audit matters (CAMs) identified in the course of the audit. The new standard also contains an auditor tenure disclosure requirement and standardizes the format of the report, among other changes. The new standard retains the pass/fail opinion of the existing auditor's report.

The new standard and other changes are subject to Securities and Exchange Commission (SEC) approval. Assuming that approval is obtained, the PCAOB expects the provisions, other than those related to CAMs, to take effect for audits for fiscal years ending on or after December 15, 2017. Provisions related to CAMs will take effect for (1) large accelerated filers, in connection with audits for fiscal years ending on or after June 30, 2019, and (2) all other filers, in connection with audits for fiscal years ending on or after December 15, 2020.

History

The new standard has culminated from an effort begun by the PCAOB in 2010. Following PCAOB staff outreach to investors, auditors, preparers of financial statements, audit committee members, and other interested parties, the PCAOB issued a concept release in 2011 and, in 2013, initially proposed a standard that would require CAMs disclosure and other elements of the recently adopted standard. Following comments and receipt of other feedback, the PCAOB re-proposed the standard in May 2016; the re-proposed version more strongly emphasized CAMs, though limited the source of potential CAMs to those communicated or required to be communicated to the audit committee. The re-proposed audit standard also added a materiality element to the meaning of CAM, relating specifically to those matters that involved especially challenging, subjective, or complex auditor judgment, further narrowing the scope of the requirement from the PCAOB's original proposal. On June 1, 2017, the PCAOB adopted the final standard.

The New Standard and Related Amendments

Critical Audit Matters. The new standard requires an auditor to disclose in its audit report any CAMs that arose during the course of the audit of a company's financial statements, or disclose that the auditor determined that there were no CAMs. The PCAOB's expectation is that at least one CAM will arise in the course of an audit. A CAM is defined as a matter that was communicated or required to be communicated to the audit committee that

(1) relates to accounts or disclosures that are material to the financial statements and (2) involved "especially challenging, subjective, or complex auditor judgment." Auditors will undertake a principles-based, audit-specific analysis to determine the presence of CAMs. The new standard includes six non-exclusive guiding factors an auditor should consider in its CAM analysis, as follows:

1. The auditor's assessment of the risks of material misstatement, including significant risks;
2. 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;
3. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
4. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
5. 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
6. The nature of audit evidence obtained regarding the matter.

For each CAM identified through the above analysis, the auditor must include the following disclosures in its audit report:

1. Identification of the CAM;
2. A description of the principal considerations that led the auditor to determine that the matter was a CAM;
3. A description of how the CAM was addressed in the audit; and
4. A reference to the relevant financial statement accounts or disclosures that relate to the CAM.

The new standard requires auditors to communicate CAMs only for the current audit period, unlike the re-proposed standard, which under certain conditions would have required the reporting of prior periods.

The CAM disclosure requirement in the new standard will not apply to emerging growth companies (as defined in the Jumpstart Our Business Startups Act); brokers and dealers reporting under Securities Exchange Act Rule 17a-5; investment companies (other than business development companies); and employee stock purchase, savings and similar plans. Auditors of these entities, however, may voluntarily include CAMs in their audit reports.

Other Audit Report Enhancements. The new standard includes other changes to the auditor's report, which the PCAOB expects will provide clarity as to an auditor's role and responsibilities, provide additional information about the auditor, and make the report more user-friendly. These additional changes include:

- <u>Auditor tenure</u> — The audit report will include a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;
- <u>Independence</u> — A statement that the auditor is required to be independent;
- <u>Addressee</u> — The audit report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are permitted);
- <u>Enhancements to basic elements</u> — Certain standardized language in the auditor's report has been changed, including the addition of 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
- <u>Standardized form of the auditor's report</u> — The opinion will appear in the first section of the auditor's report, and section titles have been added to guide the reader.

The above requirements apply to all audits performed according to PCAOB standards, including with respect to audit reports on entities that are excepted from the CAM disclosure requirement.

Implementation Schedule

Assuming SEC approval, implementation of the new standard will be phased in beginning at the end of 2017. All provisions, other than those related to CAMs, will take effect for audits for fiscal years ending on or after December 15, 2017. 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.

Implications of the New Standard

The new standard may indeed provide certain of the benefits the PCAOB seeks to realize, but it is also likely to create disclosure challenges for public companies and their audit committees. Public companies already provide substantial disclosures regarding their accounting practices, including critical accounting policy disclosures in MD&A. It is likely that CAMs identified by a company's auditor will overlap with accounting policies the company has identified as critical, and for which the company already provides substantial disclosure. Companies will need to revisit the disclosure with respect to any policies that the auditor identifies as CAMs to ensure the disclosure is accurate and complete in light of the disclosure to be provided by the auditor. In light of that consideration, management and audit committees should engage with the auditor to understand how the auditor intends to approach CAM disclosure with respect to the company, which existing accounting policies and practices would be likely to receive a CAM designation, and what CAM disclosure would look like for those matters. Although CAMs will be identified during the course of a particular audit, auditors should be able to provide the above perspective with respect to current and prior audits to help audit committees and management better understand the implications for their company. Audit committees may also wish to explore with the auditor the likely additional cost of the auditor's compliance with the new standard.

Of the other changes to the audit report, disclosure of auditor tenure may be of particular interest to certain investors. Companies with long-tenured auditors may want to consider including additional disclosure, in their proxy statement or otherwise, regarding the benefits provided by that tenure and how the audit committee considers that tenure in determining the auditor's independence.

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