

Client Alert

Corporate Practice Group

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SEC Approves Significant Changes to Auditor's Reports: New Disclosure Implications for Companies

On October 23, 2017, the Securities and Exchange Commission, or the SEC, unanimously approved new rules and amendments designed to render auditor's reports more informative to investors. These provisions were proposed by the Public Company Accounting Oversight Board, or the PCAOB, as AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. The Standard marks the first significant change to the auditor's report in more than 70 years and its adoption proved a flashpoint, with the SEC receiving 50 comment letters on the topic.

The goal of the new auditor's report is to provide investors with more meaningful information about a company's audit, including significant estimates and judgments, significant unusual transactions, and other areas of risk. The SEC believes that this new information will add to the total mix of information available to investors when making voting and capital allocation decisions.

New Required Disclosures in the Auditor's Report

The Standard alters the auditor's report by:

- requiring communication of critical audit matters (CAMs); and
- requiring additional statements concerning auditor tenure and independence, new addressees, clarification of the auditor's roles and responsibilities and a standardized form of report.

While each of these will alter the report in some fashion, it is the disclosure of CAMs that possesses the greatest potential to substantively impact the disclosures of publicly-traded companies.

Disclosure of Critical Audit Matters

CAMs Defined

The definition of a CAM is three pronged—one objective and two subjective. *First*, the CAM must be a matter that was either (a) communicated to the Company's audit committee or (b) required to be communicated to the audit

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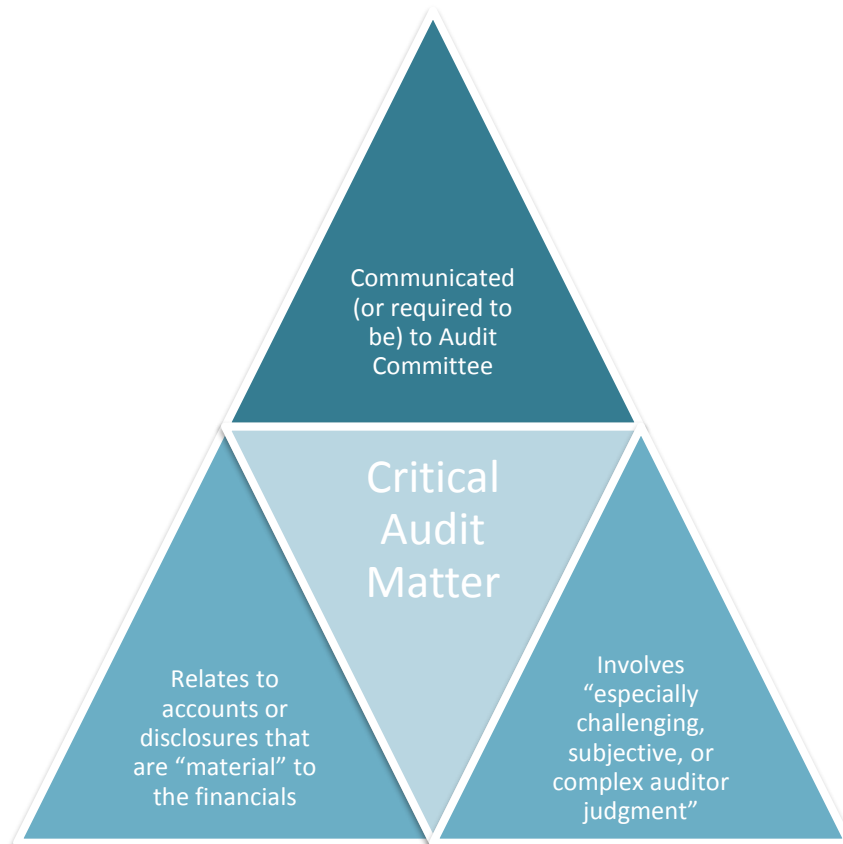
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committee.¹ *Second*, the CAM must relate to accounts or disclosures that are “material” to the Company’s financial statements. Note, however, that the CAM itself need not be material, it is only required that the account or disclosure to which the CAM relates be material. *Third*, the CAM involves “especially challenging, subjective, or complex auditor judgment.”

Figure 1. Critical Audit Matter Test



Auditor Judgment Prong -- Determinative Factors

In determining whether a matter involves “especially challenging, subjective, or complex auditor judgment,” the Standard indicates that an auditor should take into account certain factors, either alone or in combination, including:

- its assessment of the risk 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 them;

- 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 of the engagement team regarding the matter; and
- the nature of audit evidence obtained regarding the matter.

In addition to the enumerated factors, the Standard also includes a catch-all provision for the consideration of “other factors specific to the audit.”

Figure 2. Determinative Factors for the Auditor Judgment Prong



Information Disclosed

Disclosure about each CAM must include:

- a description of the CAM;
- the principal considerations that led the auditor to determine that the matter was a CAM;
- how the CAM was addressed in the audit; and
- an identification of the relevant financial statement accounts and/or disclosures that relate to the CAM.

If the auditor has not identified any CAMs, a disclosure to that effect must be included in the report.

Applicability and Effectiveness

Auditor's reports for certain types of companies are not subject to the new CAM disclosure requirements, including emerging growth companies (EGCs), mutual funds and other registered investment companies that are not business development companies and registered brokers and dealers.

The required disclosure of CAMs in auditor's reports becomes effective for annual periods ending on or after June 30, 2019 for large accelerated filers and on or after December 15, 2020 for other types of filers.

Additional Changes to Auditor's Report

The Standard also includes a number of changes to the auditor's report that are intended to (a) clarify both the auditor's role and responsibilities related to the audit of financial statements, (b) provide additional information about the auditor and (c) make the report easier to read. These changes include, among others:

- Auditor tenure – a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;
- Independence – a statement regarding the requirement for the auditor to be independent;
- Addressee – the auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted); and
- Standardized form of auditor's report – the opinion will appear in the first section of the report, and section titles will be added to guide the reader.

Applicability and Effectiveness

The additional changes to the auditor's report apply to all audits performed under PCAOB standards, including audits of EGCs.

These additional changes become effective for all audits of fiscal years ending on or after December 15, 2017.

What are the likely ramifications of these changes?

Examples of CAMs in a typical report might include a multitude of previously undisclosed matters and some commentators even believe that CAM disclosures may expand to cover significant deficiencies in internal control over financial reporting, which are not currently required to be disclosed to the public.

There is also concern that the inclusion of CAMs in auditor's reports may evolve in the same manner as company risk factors, and similar to public company disclosure practices, if any auditor includes a CAM with respect to a company in a particular industry, other auditors will be incentivized to include a comparable CAM to avoid appearing to be an outlier.

As with similar cases, all eyes will be on the cohort of "early adopter" large accelerated filers and their auditor's reports.

We recommend that companies, particularly large accelerated filers, begin work now to review and solidify with their auditor how the audit firm expects to apply the Standard and what types CAMs the company might expect to see based on prior experience. Companies should also take into account the possibility of public relations issues stemming from the disclosure of CAMs as material matters requiring challenging, subjective, or complex auditor judgment are described in greater detail in public filings. In addition, companies should remain cognizant that activist shareholders may be prepared to seize upon certain CAM disclosures as an impetus for some form of advocacy activity.

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ⁱ E.g., matters under AS 1301: *Communication with Audit Committees*.