Friday, November 3, 2017

Auditors of public companies will be required to move beyond a simple “pass or fail” opinion and include significant new information in audit reports under rules proposed this year by the Public Company Accounting Oversight Board (the "PCAOB") and recently approved by the Securities and Exchange Commission (the “SEC”). The adoption of Auditing Standard No. 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and other related rules updates were the culmination of a six-year effort that represents the most substantial change to auditor reporting requirements since the 1940s, and brings U.S. auditing standards in line with similar standards adopted (i) by the International Auditing and Assurance Standards Board (“IAASB”), (ii) in the European Union, and (iii) in the United Kingdom. The changes, designed by the PCAOB to make audit reports and financial statements more meaningful to investors and the capital markets, are likely to seriously alter the determination among auditors, audit committees, and management about whether and how significant audit issues are identified and addressed, and how such issues will impact a company’s public disclosure obligations.

A. Communication of Critical Audit Matters

The most significant impact of the new rules on public companies is the requirement that auditors identify and communicate critical audit matters (“CAMs”) within their audit report. The new rules do not supply a list of categories or types of CAMs, but instead provides a subjective, auditor-defined standard of “any matter arising from the audit of the financial statements 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) involved especially challenging, subjective, or complex auditor judgment.”

In determining whether an audit issue “involved especially challenging, subjective, or complex auditor judgment,” the rules point auditors to several factors, including:

- 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.

For every matter arising from a financial audit 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. Such documentation must be in sufficient detail such that an experienced auditor, with no previous connection with the engagement, could understand the determinations made.\(^8\)

If an auditor identifies a matter as a CAM, the auditor must include the CAM in the audit report, describe the principal considerations that led the auditor to determine that the matter is a CAM, describe how the CAM was addressed in the audit, and reference the relevant financial statements or disclosures. Alternately, if an auditor determines during the course of an audit that there are no CAMs, the audit report must contain a statement to that effect.

The new CAMs requirement is, according to SEC Chairman Jay Clayton, a response to investor requests for more specific information about how auditors reach their opinions, and is designed to provide the public with the auditor’s perspective on material audit matters discussed with the audit committee.\(^9\) The new rules for communication of CAMs go into effect for audits of “large accelerated filers” for fiscal years ending on or after June 30, 2019, and for all other issuers for fiscal years ending on or after December 15, 2020.

### B. Other Audit Report Enhancements

In addition, the new rules impose a number of enhancements designed to make audit reports more reliable and user-friendly, including:

- **Communication and Basis of Audit Opinion.** The auditor’s unqualified opinion (which will retain the existing “pass or fail” determination), along with the basis for that opinion, will appear toward the top of the audit report in the first and second sections, respectively.

- **Disclosure of Auditor Tenure and Independence Statement.** The audit report must include statements by the auditor disclosing the year in which it began serving consecutively as the issuer’s auditor, and acknowledging the requirement that the auditor maintain its independence.

- **Formatting of Audit Report.** Section titles will be clearer and standardized, and certain language describing the auditor’s responsibility to obtain reasonable assurance that financial statements are free of material misstatements will be simplified. The final audit report must be addressed to the company’s shareholders and board of directors (or equivalents).

These audit report enhancements will go into effect for all audits of fiscal years ending on or after December 15, 2017.

### C. Industry Comments and Pushback

The PCAOB’s efforts in support of these new auditing standards stretched over six years and generated over fifty comments from investors, public companies, and accounting industry insiders, many of whom advocated against their adoption. The most vigorous arguments raised questions concerning the usefulness of including CAMs in audit reports, and whether the added cost and complexity would result in any added value to users of financial statements or simply would be duplicative of, or in conflict with, management disclosures. Commenters also raised concerns about including subjective auditor positions on CAMs in an audit statement, and the conflict that could result among auditors, audit committees, and management regarding how CAMs were identified and communicated. There were also concerns about whether communications about CAMs could run afoul of accounting industry standards regarding confidential client information, and whether these communications could be the subject of frivolous civil litigation.

### D. Conclusion

Despite concerns raised by industry commenters, the SEC’s unanimous approval of the new rules indicates an inclination by the current leadership to respond to longstanding calls for greater transparency around the audits of public companies, and an alignment with similar audit standards outside the United States. However, Chair Clayton addressed many of these concerns by asserting in comments that the PCAOB and the SEC would continue to monitor the results of implementation, conduct an analysis under the PCAOB’s Post-Implementation
Review process, and be open to making future changes if the rules resulted in unintended consequences – all hallmarks of what he characterized as “high-quality regulatory decision-making.” Meanwhile, in the time leading up to the effective date, audit firms should prepare for how they intend to work with clients that are subject to the new rules on identifying, discussing, and communicating CAMs. And since the new rules do not include any templates or examples of what a CAM description should look like, there will be a learning curve as to how much detail should be provided to satisfy these new rules in the eyes of the PCAOB.


3 Auditing Standard No. 3101 applies to written audit reports in which the auditor expresses an “unqualified” opinion on the financial statements – i.e., a conclusion that the financial statements, taken as a whole, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.


7 The requirement to communicate CAMs in an audit report does not apply to: (non-issuer) broker-dealers reporting under Rule 17a-5 of the Securities Exchange Act of 1934 (the “Exchange Act”); investment companies (other than business development companies); emerging growth companies as defined by Section 3(a)(80) of the Exchange Act; or employee stock purchase, savings, or similar plans. However, auditors may elect to voluntarily include CAMs in audit reports of such entities.


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