Client Alert

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PCAOB Reproposes Standards Relating to Auditor's Reporting Model – Narrows Scope of "Critical Audit Matters" and Drops "Other Information" Requirement

Almost three years ago, the PCAOB proposed sweeping changes to the independent auditor's report that accompanies an issuer's annual report in an effort to make it more informative for investors — the first such changes in 70 years. The proposed standards were met with mixed reviews and a great deal of criticism. On May 11, 2016, the PCAOB reproposed these standards for public comment. Comments are due August 15, 2016.

The Original Proposed Standards

The standards were first proposed on August 13, 2013, in PCAOB Release 2013-005. PCAOB Chair James Doty described the proposal as a reaction to "investors' calls for more informative, insightful and relevant audit reports."[1] There were three major proposed changes.

First, auditors would be responsible for determining critical audit matters ("CAMs") and disclosing any identified CAMs in a new section of the audit report. The PCAOB defined CAMs as those matters that:

- "involved the most difficult, subjective, or complex auditor judgments";
- "posed the most difficulty to the auditor in obtaining sufficient appropriate evidence"; or
- "posed the most difficulty to the auditor in forming the opinion on the financial statements."

Second, the proposed standards would require auditors to evaluate "other information" in the issuer's annual report — i.e., information other than the audited financial statements — and determine, based on "relevant evidence obtained … during the audit," whether the other information contains "material inconsistencies" with amounts or information in financial statements or a material misstatement of fact.

Third, the new proposed audit report would include disclosures relating to the auditor's responsibilities regarding fraud, the auditor's independence and registration with the PCAOB, and, most controversially, the auditor's tenure with the issuer.[2]

[1] James R. Doty, *Developments in the Relationships Between Audit Committees and Auditors*, Northwestern University School of Law 34th Annual Ray Garrett Jr. Corporate and Securities Law Institute, May 2, 2014.

[2] The PCAOB received almost 250 comment letters on the proposed rules and received extensive input from its advisory committees. The PCAOB also convened a public forum to discuss the proposals in April 2014.

The Revised Proposed Standards

After analyzing the comments on the 2013 proposal and conducting additional outreach, the PCAOB reproposed the rule on May 11.[3] The reproposed rule (1) retains the CAMs concept, but narrows the scope of matters that constitute a CAM; (2) retains the disclosures regarding the auditor's responsibilities and tenure; and (3) eliminates the "other information" requirement.

The new proposal defines a CAM as any matter that:

- is communicated or required to be communicated to the audit committee;
- involved especially challenging, subjective or complex auditor judgment; and
- relates to accounts or disclosures material to the issuer's financial statements.

By limiting CAMs to issues brought to the attention of the audit committee and deemed material to the financial statements, the new rules appear to address some of the concerns expressed by the audit community that the PCAOB's original definition of a CAM would put auditors in the position of disclosing information that management is not required to provide to investors or, alternatively, that is the sole province of management. To assist the auditor in determining whether a matter is a CAM, the reproposed standard includes a nonexclusive list of six factors for the auditor to take into account in determining whether a matter involved especially challenging, subjective or complex auditor judgment. Also, the new rules would require a description of: (i) the principal considerations that led the auditor to determine that a particular matter is a CAM, (ii) how it was addressed in the audit, and (iii) the relevant financial statement accounts and disclosures. If there are no CAMs, the auditor would be required to state that determination in the auditor's report. The new rules also require the auditor to document (in work papers or in materials presented to the audit committee) the basis for its determination regarding each matter determined to be a CAM.

Similar to the original proposed standards, the PCAOB also proposed new disclosures in the auditor's report, including: (i) clarification of the auditor's existing responsibilities; (ii) a statement about auditor independence; (iii) clarification that the auditor's opinion provides reasonable assurance regarding material misstatements (whether those misstatements might arise due to error or fraud); and (iv) a statement of the auditor's tenure.

Unlike the 2013 proposal, however, 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. Notably, the PCAOB decided not to repropose the "other information" auditing standard at this time.

Discussion of reproposal at the PCAOB's Standing Advisory Group meeting

At the PCAOB's Standing Advisory Group meeting on May 18, 2016, committee members representing a wide cross section of stakeholders, including regulators, investor representatives, users and preparers of financial statements, and members of academia (among others) expressed general support for the new standards. Committee members, however, engaged in an extensive debate regarding the lack of a disclosure requirement in the new rules explaining the materiality threshold, either quantitative or qualitative, for determining whether a matter is material to the financial statements (as required in the UK by the Financial Reporting Council). PCAOB members continue to debate, among other things, whether

[3] https://pcaobus.org/Rulemaking/Pages/Docket034.aspx

the new definition of a CAM gives auditors too much discretion in determining what constitutes a CAM, and whether audit tenure is a useful disclosure.

While the debate over these issues will likely continue and even though it retains the existing pass/fail model, this reproposal makes clear that the auditor's report is likely to look dramatically different from the model that has been used for decades. Auditors and financial statement preparers should be prepared for discussions about CAMs, greater disclosure, and generally more expensive audits.

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