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Client Alert

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PCAOB Adopts New Audit Reporting Model

On June 1, 2017, the Public Company Accounting Oversight Board (PCAOB) adopted a series of new audit standards that will impact the audit reporting model for public companies. The standards must still receive final approval from the Securities and Exchange Commission, but assuming the SEC approves them, the new standards will make substantial changes to the form of the annual auditor's report, most notably by requiring a new discussion of "critical audit matters." We discuss the new standards below.

Overview

After more than six years of public outreach, the PCAOB has adopted a new auditor reporting standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (AS 3101)[1] and related amendments to its auditing standards that will require the auditor to provide new information about the audit in an effort to make the auditor's report more informative and relevant to investors and other financial statement users. The final standard retains the pass-fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- <u>Communication of critical audit matters</u>—matters communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements; and (2) involve especially challenging, subjective or complex auditor judgment;

- <u>Disclosure of auditor tenure</u>—the year in which the auditor began serving as the company's auditor; and

- <u>Other changes to the auditor's report</u>—a number of other improvements to the auditor's report intended to clarify the auditor's role and responsibilities and make the auditor's report easier to read.

In adopting the final standard, the PCAOB noted that while the auditor's report has generally remained unchanged since the 1940s, companies' operations have become more complex and global, and the financial reporting frameworks have evolved toward an increasing use of estimates, including fair value measurements. Although auditors often perform procedures during the audit involving challenging, subjective or complex judgments, the auditor's report does not communicate this information to investors. The PCAOB believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management. It noted that outside the United States, other regulators and standard setters have already adopted expanded auditor reporting.

[1] The complete text of the release, No. 2017-001, can be found at https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf.

Critical Audit Matters

The new form of auditor's report will require the auditor to discuss "critical audit matters" (also referred to as CAMs) arising from the current period's audit of the financial statements, or state that the auditor determined that there are no critical audit matters.[2] A critical audit matter is defined as a matter 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 a matter involved especially challenging, subjective or complex auditor judgment, the auditor must take into account, alone or in combination, certain 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.

In communicating each critical audit matter, the auditor must identify the critical audit matter, describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, describe how the critical audit matter was addressed in the audit and refer to the relevant financial statement accounts or disclosures. The auditor is required to document whether or not a particular matter was determined to be a critical audit matter and the basis for such determination whenever the matter was (1) communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements.

Critical audit matters are determined using a principles-based framework and the PCAOB anticipates that the level of auditor effort will depend on the nature and complexity of the audit. This determination would in turn depend on the complexity of the operations and accounting and control systems of the company.

The final standard provides that each critical audit matter relates to accounts or disclosures that are material to the financial statements. Under the final standard, "relates to" clarifies that the critical audit matter could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. As an example, the PCAOB posits that the auditor's evaluation of the company's goodwill impairment assessment could be a critical audit matter if goodwill was material to the financial statements, even if there was no impairment; it would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company's impairment policy and goodwill. In addition, a critical audit matter may

[2] International auditing standards require that the auditor identify "key audit matters," which are defined as matters that, in the auditor's professional judgment, were of the most significance in the audit of the financial statements.

not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. In defining "relates to" in this way, the PCAOB rejected an argument raised by several commenters (predominantly public companies and accounting firms) that the definition was too broad and suggested modifying the materiality component such that a critical audit matter would itself have to be material to the financial statements as a whole, rather than relating to accounts or disclosures that are material to the financial statements.

Critical audit matters will be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). The source will include auditor communication requirements under AS 1301, Communications with Audit Committees; other PCAOB rules and standards; and applicable law; as well as communications made to the audit committee that were not required. This approach is intended to be very broad and will not require the auditor to determine whether matters communicated to the audit committee were required to be communicated. Required communications to the audit committee generally include the areas in which investors have expressed particular interest in obtaining information in the auditor's report, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements.

The final standard does not exclude any required audit committee communications from the source of critical audit matters. To the extent that any such communication met the critical audit matter definition (including that it (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective or complex auditor judgment), the PCAOB believes it will be an appropriate subject for an auditor to communicate as a critical audit matter.

The PCAOB expects that, in most audits to which the requirement to communicate critical audit matters applies, the auditor will determine that at least one matter involved especially challenging, subjective or complex auditor judgment. There may be critical audit matters even in an audit of a company with limited operations or activities. Nonetheless, the PCAOB acknowledges that there may be circumstances in which the auditor determines there are no matters that meet the definition of a critical audit matter and, in those circumstances, the auditor will communicate in the auditor's report that there were no critical audit matters.

Other Changes

The final standard also includes a series of other changes to the auditor's report that are intended to clarify the auditor's role and responsibilities related to the audit of the financial statements, provide additional information about the auditor and make the auditor's report easier to read, including the following:

- <u>Auditor tenure</u>—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 auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted);
- <u>Other basic elements</u>—certain standardized language in the auditor's report has been changed, including adding 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.

In making the tenure determination, the PCAOB believes that the disclosure of tenure should reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit. Additionally, if a company went public and maintained the same auditor, auditor tenure will include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Effective Dates

The final standard remains subject to final approval by the SEC, which will open another public comment period before taking further action. Assuming approval by the SEC, the final standard will take effect in stages. The new auditor's report format, tenure and other information (other than the discussion of critical audit matters) would be required in audit reports concerning audits for fiscal years ending on or after December 15, 2017. The communication of critical audit matters for audits of large accelerated filers would be required for audits for fiscal years ending or after June 30, 2019. The communication of critical audit matters for other companies would be required for audits for fiscal years ending on or after December 15, 2020. Notably, the communication of critical audit matters would not be required for audits of emerging growth companies, broker-dealers, investment companies (other than business development companies), and employee stock purchase plans, savings plans and similar benefit plans.

Next Steps for Public Companies

We expect that audit firms will begin modifying their audit policies and procedures immediately in response to the PCAOB's action. Some of the changes, such as the disclosure of audit tenure, should not require substantial effort. The requirement to report on critical audit matters, however, will require additional effort on the part of auditors to make the necessary determinations and will require companies to budget the process into the audit timeline. Not only will the auditors require time to prepare the required disclosure, but audit committees, financial reporting personnel and counsel will require additional time to vet the disclosure and take appropriate responsive action.

The identification of critical audit matters—by definition—will clearly involve the exercise of judgment and likely result in lengthy disclosures. Significantly, given that the auditor must document whether or not a matter was determined to be a critical audit matter and the basis for such determination, PCAOB inspections staff may view this requirement as an opportunity to scrutinize the auditor's decision-making process or, alternatively, auditors may be more hesitant to conclude a matter discussed with the audit committee was not a critical audit matter. These disclosures could also lead to new claims against auditors under state and federal law based on the selection of matters the auditor deemed to be critical audit matters.

Although the PCAOB does not have authority to regulate the conduct of audit committees or management, the new standard will likely affect the company's own disclosure, which both the audit committee and senior management will need to address before the Form 10-K and financial statements are completed. Issuers and their audit committees should begin an immediate dialogue with their audit firms to assess how those firms intend to implement the final standard and what additional work it will require on the part of the issuer.

HUNTON&
WILLIAMS

Contacts

Matthew P. Bosher
mbosher@hunton.com

Shaswat (Shas) K. Das
sdas@hunton.com

Scott H. Kimpel
skimpel@hunton.com