July 20, 2017

PCAOB Adopts New Auditor Reporting Standard

After more than six years of outreach and public comment, on June 1, 2017, the Public Company Accounting Oversight Board ("PCAOB") adopted a new auditor reporting standard[1] that, if approved by the SEC, would significantly expand the existing auditor's report. The new standard would require the auditor's report to include: (i) disclosure of "critical audit matters" ("CAMs"), (ii) disclosure of auditor tenure, and (iii) other related improvements to the auditor's report. The new standard would generally apply to audits conducted under PCAOB standards, although broker-dealers, investment companies other than business development companies, employee benefit plans and emerging growth companies would be exempt from the CAM disclosure requirement. In adopting these changes, the PCAOB intended to make the auditor's report more informative and relevant to investors and other financial statement users. While the new standard is subject to SEC approval and its implementation would be phased in over time, public companies and their audit committees should consider engaging with their auditors now to discuss how their auditors expect to approach the process for identifying and disclosing CAMs as well as understand any other potential impacts of the new standard.

Critical Audit Matters

The CAM disclosures are the heart of the new changes. Under the new standard, a CAM is any matter arising from the audit of the financial statements that (1) was communicated or required to be communicated to the audit committee, (2) relates to accounts or disclosures that are material to the financial statements, and (3) involved especially challenging, subjective, or complex auditor judgment. The adopting release contained a helpful flowchart (reproduced on the attached Annex A) that illustrates the process for determining and communicating CAMs under the new standard.

Audit Committee Communications. All communications between an auditor and the audit committee (and any required communications that are not actually made) would be the source for CAMs. Under PCAOB standards, auditors are required to communicate to the audit committee, among other things: significant risks identified by the auditor; certain matters regarding the company's accounting policies, practices, and estimates; significant unusual transactions; certain matters regarding the auditor's evaluation of the company's relationships and transactions with related parties; and other matters arising from the audit that are significant to the oversight of the company's financial reporting process. While some commenters had raised concerns that using audit committee communications as the source for CAMs could "chill" communications between the auditor, management and the audit committee, the PCAOB noted that the communication requirements are not changing and stated its belief that, given the breadth of those requirements, there would likely be few, if any, relevant communications that would be affected.

Materiality. Each CAM must relate to a material account or disclosure in the financial statements. A CAM 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, and it may not be material to the financial statements as a whole. The adopting release noted, as an example, that an auditor's evaluation of a company's goodwill impairment assessment could be a CAM if goodwill was material to the company's financial statements, even if there was no impairment.

[1] AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. The PCAOB's adopting release for the new standard can be found here.

Auditor Judgment. The new standard does not specify any items that would always constitute CAMs, but instead establishes a principles-based framework for determining the existence of a CAM. Under the new standard, an auditor would take into account, alone or in combination, the following non-exclusive list of factors when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

- 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 measure uncertainty;
- the nature and timing of significant unusual transactions and the extent of audit effort and judgment related to those 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.

The new standard, which the PCAOB believes is responsive to investors' requests, was designed to elicit more information about the audit directly from the auditor. In the adopting release, the PCAOB stated that it expects that, for most audits, the auditor will determine that at least one matter constitutes a CAM. However, the PCAOB acknowledged that there may be circumstances in which the auditor determines there are no matters that meet the definition of a CAM. In such an event, the auditor would be required to disclose that there were no CAMs.

Communication Requirements. After determining that a CAM exists, the auditor must include a description of the CAM in the auditor's report. For each CAM, the auditor would:

- identify the CAM;
- 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
- refer to the relevant financial statement accounts or disclosures that relate to the CAM.

According to the adopting release, the intent of communicating CAMs is to provide information about the audit of a company's financial statements that would be "useful to investors." Consequently, an auditor's description of the principal considerations should provide "a clear, concise, and understandable discussion" of why a matter involved especially challenging, subjective, or complex auditor judgment and avoid the use of boilerplate language. Furthermore, auditors should avoid the use of highly technical accounting and auditing terms when describing how they addressed a CAM in the audit.

Auditor Tenure

The new standard would also require disclosure of the auditor's tenure, specifically, the year in which the auditor began serving consecutively as a company's auditor. Some commenters, primarily companies and accounting firms, did not support disclosure of auditor tenure in the auditor's report and questioned the relevance and value of this disclosure. In contrast, investor commenters stated that information on auditor tenure would be useful, for example, in connection with deciding whether to vote to ratify the appointment of the auditor. While acknowledging the "growing trend toward voluntary disclosure of auditor tenure," the PCAOB adopted the auditor tenure disclosure requirement because voluntary disclosure is not provided for "a significant number" of audits subject to the PCAOB's jurisdiction and it believed that such public disclosure is important and in the public interest.

Other Changes to the Auditor's Report

The new standard also includes a number of additional changes to the auditor's report that are intended to clarify the auditor's role and responsibilities related to the audit and make the report easier to read. These changes include: (a) including a statement that the auditor is required to be independent; (b) addressing the auditor's report to a company's shareholders and board of directors; (c) changing some standardized language, including adding the phrase "whether due to error or fraud" when describing the auditor's responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement; and (d) standardizing the format, where the auditor's opinion would be required to appear in the first section of the auditor's report and section titles would be added to help guide the reader.

Applicability; Effective Dates

The new standard would generally apply to audits conducted under PCAOB standards. The CAM disclosure requirement does not apply to emerging growth companies, registered broker-dealers, investment companies other than business development companies, and employee benefit plans.

If approved by the SEC, the new standard and the related amendments to auditing standards would be phased in over time, which would give accounting firms and companies and their audit committees time to prepare for the new requirements. The new standard would be implemented as follows:

- New auditor's report format, auditor tenure, and other information (not including communication of CAMs): audits for fiscal years ending on or after December 15, 2017;
- For those entities to which the communication of CAMs applies, there is a phase-in schedule:
  - For large accelerated filers: audits for fiscal years ending on or after June 30, 2019; and
  - For all other companies: audits for fiscal years ending on or after December 15, 2020.

Auditors may voluntarily comply before the relevant effective date, at any point after SEC approval of the new standard.

Practical Considerations

The PCAOB appeared to minimize concerns that the CAM disclosure requirement would result in the disclosure of "original information" (which refers to information about a company disclosed by the auditor that has not been previously disclosed by the company). Indeed, the PCAOB expressed its belief that "[t]o the extent that an auditor's decision to communicate a [CAM] incents the company to expand or supplement its own disclosure . . . would be an indirect benefit of the standard." As a result, companies and their audit committees will need to put in place a process for reviewing any proposed CAM disclosure with their auditors to evaluate whether any changes should be made to the company's SEC disclosures.

Because the CAM disclosure will not first apply until March 2, 2020 (the 10-K filing deadline for a large accelerated filer with a 12/31 fiscal year-end), companies and their audit committees should consider asking their auditors in the next audit to prepare an example of what the disclosure would look like applied to that audit to better understand how the auditor would approach the identification of CAMs and the related disclosure in the auditor's report.

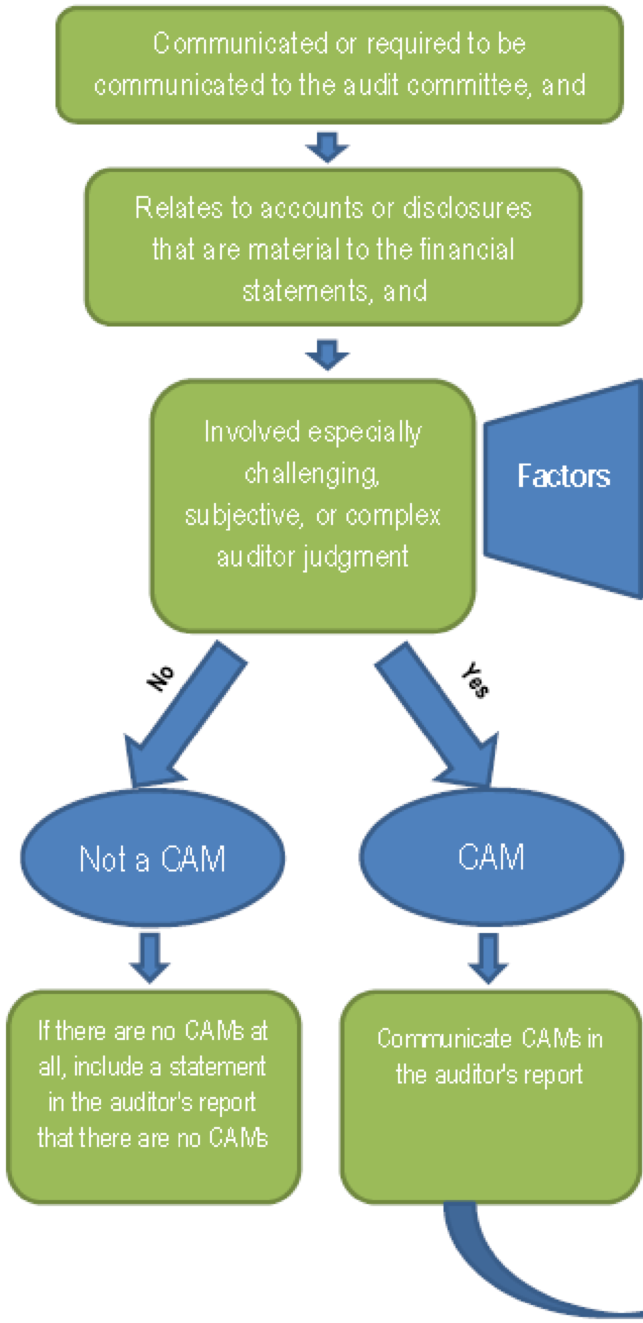
CAM disclosures are reminiscent of the disclosure of critical accounting estimates, which most companies include in their MD&A. Unfortunately, many of these disclosures – which are intended to provide greater transparency into the highly uncertain judgments and estimates in financial statements – have frequently simply repeated much or all of the significant accounting policies disclosure in the financial statement footnotes. CAM disclosure will be required when an "especially challenging, subjective, or complex auditor judgment" is required that involves an account or disclosure that is material to the financial statements. Where an account is material to the financial statements, it will likely be difficult for the auditor to resist disclosing **something** about the judgments in the audit of that area. In all events, companies should make sure that there is a consistent story between the CAM disclosures in the audit report and the critical accounting estimate disclosures in the MD&A.

In the adopting release, the PCAOB observed that some commenters, including many smaller accounting firms, preparers and audit committee members, were either less supportive or outright opposed to the new standard. The standard requires the approval of the SEC, which will seek public comment on the proposal. Although the SEC has never failed to approve a PCAOB-adopted rule, it is worth noting that SEC Chairman Jay Clayton, in his first public speech as Chairman, discussed his concern with regulatory compliance costs and specifically noted that small incremental requirements have a cumulative impact. He also recognized that when third parties, such as auditors, outside counsel, and consultants, are involved in regulatory compliance efforts, the costs – both financial costs as well as the cost in terms of time – can "skyrocket." In light of Chairman Clayton's recent remarks, interested stakeholders should consider submitting comments on the new standard during the SEC's notice and comment process, particularly if they expect incremental increases in audit and legal fees in connection with preparing and reviewing new CAM disclosures.

Finally, in light of the new standard's disclosure requirement of auditor tenure, audit committees of companies with long-tenured auditors should consider enhanced disclosures in their proxy statements (e.g., the audit committee report or in the auditor ratification proposal) about the benefits of having a long-tenured auditor as well as how the audit committee monitors auditor independence.

If you have any question about this Alert, please contact any member of Ropes & Gray's securities & public companies practice group or your usual Ropes & Gray contact.

Annex A: Determining and Communicating CAMs under AS 3101



FACTORS THE AUDITOR SHOULD TAKE INTO ACCOUNT IN DETERMINING CAMs:

a. The auditor's assessment of the risks of material misstatement, including significant risks;
b. 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;
c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
e. 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
f. The nature of audit evidence obtained regarding the matter.

COMMUNICATION REQUIREMENTS

a. Identify the critical audit matter;
b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
c. Describe how the critical audit matter was addressed in the audit; and
d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.