PCAOB Adopts New Standard Expanding Auditors' Reports

June 7, 2017

Requires Disclosure of Company-Specific Audit Matters

On June 1, 2017, the Public Company Accounting Oversight Board approved a new **audit standard** that will introduce changes to the content of the auditor's report on financial statements. While the pass/fail nature of the auditor's opinion on the fairness of the presentation of the financial statements will remain, under the revised standard, the auditor's report will also be required to include disclosure of critical audit matters ("CAMs") that arose during the audit period. The audit standard also requires disclosure of auditor tenure and updates to the format and presentation of the auditor's report. Given that companies already must disclose critical accounting policies, it remains to be seen whether these new requirements will provide new information of use to investors.

The new audit standard and related amendments are subject to SEC approval. Once they are approved, disclosure of auditor tenure and changes to format and presentation will be required for audits of fiscal years ending on or after December 15, 2017. CAM disclosure will not be required for large accelerated filers until audits for fiscal years ending on or after June 30, 2019, and for all other filers for fiscal years ending on or after December 15, 2020.

The requirement for auditors to include CAM disclosure will generally apply to all audit reports filed with the SEC, including by foreign private issuers, but will not apply to audit reports of emerging growth companies, brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than business development companies and benefit plans.

Background

The PCAOB believes that existing auditors' reports fail to reflect the increased complexity of financial reporting where auditors often perform procedures involving challenging, subjective or complex judgments, and investors are not aware of such procedures since the auditor's report simply provides a conclusion. While SEC registrants must disclose critical accounting policies involving challenging, subjective or complex judgments, the PCAOB believes that providing additional CAM information could benefit investors by facilitating analysis of company financial statements and other disclosures and could help investors and analysts identify targeted questions to engage management. The PCAOB has also noted that international regulators and standard setters such as the International Auditing and Assurance Standards Board, the European Union and the Financial Reporting Council in the United Kingdom have adopted requirements for expanded auditor reporting to communicate information specific to the particular audit.

While the PCAOB reported it had received widespread investor interest in additional information about the financial statement audit, it also received feedback from financial statement preparers, audit committees and auditors. Many cited concerns that this disclosure has the potential to chill communications between audit committees and auditors and could lead to a requirement that auditors disclose original information about a company not previously disclosed by the company and/or not required to be disclosed by the company under the financial reporting rules applicable to SEC registrants. In response, the PCAOB made certain modifications to their initial proposal, but the final standard did not eliminate the possibility that original information can be disclosed by the auditor. In fact, the standard acknowledges that the auditor may disclose such information if needed to describe the principal considerations of the auditors' CAM determination or in connection with how the matter was addressed in the audit.

Critical Audit Matters

Under the new standard, auditors will be required to disclose CAMs in a new section of the audit report or affirmatively state that there were no CAMs for that period. A CAM is a matter that was communicated or required to be communicated to the audit committee and that:

- relates to accounts or disclosures that are material to the financial statements; and
- involved "especially challenging, subjective, or complex auditor judgment."

Factors that the auditors will use in determining if a matter is a CAM include, but are not limited to:

- the risk of material misstatement;
- the degree of auditor judgment related to areas of the financials where management exercised significant judgment or estimation, including estimates with significant measurement uncertainty;
- unusual transactions and the extent of audit effort and judgment related to them;
- the degree of auditor subjectivity in applying audit procedures to the matter in question;
- the nature and extent of audit effort required to address a matter, including bringing in others outside the engagement team (from the comments of the PCAOB it is clear that they feel that any referral to an auditor's national office could fall into this category); and
- the nature of the audit evidence obtained regarding the matter.

For each CAM that is identified, the auditors will describe the CAM, the principal considerations that led the auditor to believe that the matter is a CAM, how the CAM was addressed in the audit, and the relevant financial statement accounts or disclosures related to the CAM.

The PCAOB describes the CAM determination as "principles-based" and expects that the level of auditor efforts will vary depending on the nature and complexity of the audit. The PCAOB expects that an auditor's report will include at least one CAM.

The PCAOB is very clear that it is looking for individual comments related to the particular company being audited and not boilerplate disclosure of general applicability. The new standard also explains that the description of CAMs should include no disclaiming, qualifying, restricting or minimizing language on the responsibilities of the auditors or the opinion on the financial statements or imply that a separate opinion is being provided on the CAMs or disclosures to which they relate.

The SEC already requires companies to discuss "critical accounting policies" in their SEC filings. These are defined by the SEC as the accounting policies that "are both most important to the portrayal of the company's financial condition and results and which require management's most difficult, subjective or complex judgments."[1] There is substantial similarity between this definition and that adopted for CAMs. As a result, we expect that auditors will look at critical accounting policies in formulating any CAMs, and we anticipate that there may be substantial overlap between them. We would note that, despite formal guidance issued by the SEC in 2001 and 2003 outlining disclosure requirements for critical accounting policies and estimates, disclosure of them has become increasingly boilerplate, and it remains to be seen whether CAM disclosure will similarly become boilerplate, despite the PCAOB's urging to the contrary.

[1] ***Strengthening the Commission's Requirements Regarding Auditor Independence***, **SEC Rel. No. 33-8183 (Mar. 27, 2003); *see also Cautionary Advice Regarding Disclosure About Critical Accounting Policies,* SEC Rel. No. 33-8040 (Dec. 12, 2001).**

Additional Improvements to the Auditor's Report

The format of the auditor's report under the new standard will be revamped. The new auditor's report moves the auditor's opinion paragraph on fair presentation to the lead section and includes section titles to improve readability. Revisions to the content of the auditor's report include the addition of a statement that the auditor is required to be independent, the inclusion as addressees of shareholders and directors (or their equivalents, as well as any other addressee parties) and new standardized language about the role and responsibilities of the auditor.

The PCAOB added a requirement to include in the audit report the number of consecutive years the auditor has been engaged by the company. Auditor tenure will be calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure. If the auditor is uncertain as to the year the auditor became the company's auditor, the auditor will so state and provide the earliest year of which the auditor has knowledge. If a company goes public and maintains the same auditor, auditor tenure will include the years the auditor consecutively served as the company's auditor both before and after the company became subject to SEC reporting requirements. Because most investment companies have common accounting, internal control, and oversight at the group level, auditor tenure will be calculated from the time that the auditor began serving consecutively as the auditor of any investment company in the group.

Implications

A number of fundamental concerns raised by stakeholders throughout the standard-setting process about the potential negative consequences of the CAM requirements and the relative value added by the communications to investors are still present in the final standard.

It remains unclear what benefit, if any, financial statement users will reap from the disclosure of critical audit matters in addition to the existing disclosure of critical accounting policies already required in annual and quarterly reports. Through guidance and comment letters from the SEC staff, the SEC has advised companies to improve the discussion of critical accounting policies in MD&A to be more insightful and to supplement, rather than repeat, information already provided in financial statement footnotes. Auditors and the PCAOB will face similar disclosure challenges. In remarks approving the standard, PCAOB board member Steven Harris called attention to the "difficulty of effectively inspecting against and enforcing compliance with such a subjective standard."[2]

Although the language in the final standard focuses the need for disclosure on matters involving especially challenging, subjective or complex auditor judgment, there is still a potential for auditors to simply include all significant issues communicated to the audit committee regarding the audit, including the company's critical accounting policies. The reality is that auditors are at risk of being sued on the basis of their report, including the CAM discussion, in the event of a subsequent financial restatement or other financial difficulties at the audit client. We would not be surprised if the number of CAMs included in audit reports proliferates over time without any incremental provision of useful information. As experience has shown with respect to risk factor disclosure in public filings with the SEC, CAMs will likely be seen to provide protections to auditors in the same manner as risk factors are thought to provide protection to companies.

Because the discussion will appear in the company's own filings and express judgments about the company, as well as provide a basis for liability against the company, we believe there is also a risk that companies may insist on reviewing, and potentially negotiating and approving, all CAMs before finalizing

[2] Steven B. Harris, Statement on Adoption of an Auditing Standard on the Auditor's Report at PCAOB Open Board Meeting, Washington D.C. (June 1, 2017) (*available at* **https://pcaobus.org/News/Speech/Pages/Harris-statement-auditors-report-standard-adoption-6-1-17.aspx**).

the audit. At the same time, because the engagement team will recognize that communications with the audit committee will likely trigger a need for CAM disclosure, or at least require the exercise of judgment to determine whether the communication is a CAM (and document those processes), we believe that a requirement to discuss CAMs in the audit report could have a chilling effect on these discussions.

Timeline for Adoption

For audits on financial statements for fiscal years ending on or after:

December 15, 2017	Inclusion of all provisions for all filers, including auditor tenure, statements on auditor independence, and other standardized presentation requirements, except CAM requirements
June 30, 2019	CAM provisions for large accelerated filers
December 15, 2020	CAM provisions for all other applicable filers

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Bruce K. Dallas	**650 752 2022**	**bruce.dallas@davispolk.com**
Alan F. Denenberg	**650 752 2004**	**alan.denenberg@davispolk.com**
Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Sophia Hudson	**212 450 4762**	**sophia.hudson@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
John B. Meade	**212 450 4077**	**john.meade@davispolk.com**
Byron B. Rooney	**212 450 4658**	**byron.rooney@davispolk.com**
Richard J. Sandler	**212 450 4224**	**richard.sandler@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**
Ning Chiu	**212 450 4908**	**ning.chiu@davispolk.com**