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PCAOB adopts final standard to significantly change the auditor's report

The standard requires auditors to report information about critical audit matters and auditor tenure.

What you need to know

- ▶ The PCAOB adopted a final standard that requires auditors to include significantly more information in their auditor's reports. The standard is subject to approval by the SEC, and interested parties will have an opportunity to provide comments.
- ▶ The standard requires auditors to include in the report information about matters that they communicated or were required to communicate to the audit committee that relate to material accounts or disclosures and involved especially challenging, subjective or complex auditor judgment. These requirements are effective for annual periods ending on or after 30 June 2019 for large accelerated filers and 15 December 2020 for all other filers.
- ▶ The standard requires auditors to add information about auditor tenure, clarify the language about the auditor's responsibilities and change the organization and format of the report. Those requirements are effective for audits of financial statements for annual reporting periods ending on or after 15 December 2017.

Overview

The Public Company Accounting Oversight Board (PCAOB or Board) adopted a final auditing standard¹ aimed at making the auditor's report more relevant and informative for investors and other financial statement users. The standard retains the pass/fail audit opinion but requires auditors to include in their reports:

- ▶ A discussion of critical audit matters (CAMs), which the standard defines as items communicated to the audit committee or required to be communicated to the audit committee that related to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective or complex auditor judgment
- ▶ Information on auditor tenure
- ▶ A statement that auditors are required to be independent
- ▶ The phrase "whether due to error or fraud" in the description of the auditor's responsibilities to obtain reasonable assurance about whether the financial statements are free of material misstatement

The standard, which is subject to approval by the Securities and Exchange Commission (SEC), also standardizes the format of the auditor's report by requiring auditors to first state their opinion and include section titles. The final standard is substantially the same as the standard the PCAOB proposed in 2016.²

The standard generally applies to audits conducted under PCAOB standards, but CAMs do not have to be communicated for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5; investment companies other than business development companies; employee stock purchase, savings and similar plans; and emerging growth companies.

Other standard-setting bodies around the world have already made similar changes to the auditor's report. International Standards on Auditing (ISA)³ require discussion of key audit matters (KAMs) in auditor's reports on financial statements for periods ending on or after 15 December 2016. The European Union will require an expanded auditor's report for periods ending on or after 30 June 2017.

Key considerations

Critical audit matters

The standard defines CAMs as matters communicated to the audit committee or required to be communicated to the audit committee related to accounts or disclosures that are material to the financial statements and that involved especially challenging, subjective or complex auditor judgment. In determining whether a matter involved especially challenging, subjective or complex

auditor judgment, the auditor is required to take into account, alone or in combination, 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 the 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
- ▶ The nature of audit evidence obtained regarding the matter

The final rule requires auditors to evaluate the same population of items the PCAOB proposed in 2016. However, the standard doesn't list required CAMs or set an expectation that certain items will be CAMs in all cases (e.g., matters considered significant risks may be CAMs in certain cases but not in others). As a result, for example, while revenue recognition is presumed to be a fraud risk and all fraud risks are significant risks under PCAOB standards, a matter related to revenue recognition that did not involve especially challenging, subjective or complex auditor judgment will not be considered a critical audit matter (CAM) under the standard. The standard also requires auditors to document in their workpapers their reasons for determining whether each matter communicated or required to be communicated to the audit committee is a CAM.

An auditor that does not identify any CAMs is required to include a statement to that effect in the "Critical Audit Matters" section of the auditor's report. However, the Board said in the standard that it expects that, in most audits, the auditor will identify at least one CAM.

For each CAM, auditors are required to (1) identify the matter, (2) describe the principal considerations in determining that the matter was a CAM, (3) describe how the matter was addressed in the audit and (4) refer to the relevant financial statement accounts or disclosures.

Auditors could satisfy the requirement to describe how they addressed each CAM by (1) describing their response or approach that was most relevant to the matter; (2) providing a brief overview of procedures performed; (3) providing an indication

of the outcome of those procedures; or (4) providing key observations with respect to the matter, or a combination of these elements. The final standard does not prescribe specific items to be included.

The definition of a CAM and the requirements to determine and describe a CAM are substantially the same as what the PCAOB proposed in 2016.

The Board did not make any changes to the standard in response to concerns we and others raised about the possibility that the auditor might have to disclose information that the company has not previously disclosed. However, in the adopting release, the PCAOB discussed the application of the standard to matters that don't relate to accounts or disclosures that are material to the financial statements and therefore cannot be CAMs. The discussion included examples related to (1) a potential loss contingency that was communicated to the audit committee but was determined to be remote and was not recorded in the financial statements or disclosed, (2) a potential illegal act that the company wasn't required to disclose and (3) the determination, by itself, that there is a significant deficiency in internal control over financial reporting.

How we see it

- ▶ The discussion of these items in the adopting release should help mitigate the possibility that auditors might disclose original information.
- ▶ The PCAOB's definition of a CAM is largely aligned with the ISA definition of a key audit matter, but there are differences that may result in different outcomes.

The standard notes that the language used to communicate a CAM should not imply that the auditor is providing a separate opinion on the CAM or on the accounts or disclosures to which it relates. The standard says it also would not be appropriate for the auditor to use language that could call into question the auditor's responsibility for the CAMs or the auditor's opinion on the financial statements, taken as a whole.

If the SEC approves the standard, these requirements will be effective for annual periods ending on or after 30 June 2019 for large accelerated filers and reporting periods ending on or after 15 December 2020 for all other filers.

Other changes to the auditor's report

The standard requires the auditor's report to include the year the auditor began serving consecutively as the company's auditor. The PCAOB said its intent is for the disclosure to reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and predecessors to the company being audited. Auditors that are uncertain about the length of their relationship with a company must state that fact and provide the earliest year that they are sure of.

The standard also revises the language in the auditor's report to add a statement that the auditor is required to be independent and add the phrase "whether due to fraud or error" to the description of the auditor's responsibility to obtain reasonable assurance that the financial statements are free of material misstatement. In addition, it revises the format of the auditor's report to require that the auditor's opinion paragraph be the first section of the report and to require the use of section titles.

If the SEC approves the standard, these changes will be effective for audits of financial statements for annual periods ending on or after 15 December 2017.

How we see it

Determining auditor tenure may require research when there have been audit firm or company mergers, acquisitions or other changes in ownership structure.

What's next

The final standard is subject to approval by the SEC, and interested parties will have an opportunity to provide comments. Management and audit committees should familiarize themselves with the requirements of the standard.

Endnotes:

- 1 PCAOB Release No. 2017-001, Auditing Standard – *The Auditor's Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion And Related Amendments To PCAOB Standards*.
- 2 PCAOB Release No. 2016-003, Proposed Auditing Standard – *The Auditor's Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion And Related Amendments To PCAOB Standards*.
- 3 ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, and ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*.

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