WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

SEC Approves PCAOB Standard Requiring Disclosure of Critical Auditor Judgments

October 30, 2017

AUTHOR

Jeffrey S. Hochman

On October 23, 2017, the SEC unanimously approved[1] the Public Company Accounting Oversight Board's ("PCAOB") proposed new auditor reporting standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments to other standards.[2] This new standard requires auditors to describe in the auditor's report any "critical audit matters" ("CAMs") that arose during the audit. The standard defines a CAM as an issue that the auditor communicated to the audit committee relating to material accounts or disclosures that involved "especially challenging, subjective or complex auditor judgment." The auditor's report must contain a discussion of the CAM, including why the issue was identified as a CAM and how it was addressed in the audit. The new rules also change the organization and format of the auditor's report and require that the report state the auditor's tenure with the company. These changes are intended to encourage auditors to expand beyond the boilerplate language in the auditor's report to communicate to investors the complex, subjective judgments necessary to reach a conclusion on a company's financial statements.

Critical Audit Matters

The newly adopted rules require an auditor to communicate in the auditor's report any CAMs arising from the current period's audit or state that the auditor determined that there are no CAMs. A CAM is defined as any matter arising from an audit of financial statements that was communicated or required to be communicated to the audit committee and that

[1] See SEC Release No. 34-81916, available here.

[2] See PCAOB Release No. 2017-001, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, available here, and our related client memorandum, available here.

(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 new rules provide that auditors should take into account the following factors, as well as other factors specific to the audit:

- 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 disclosing each CAM in its report, the auditor must:

- 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.

For each matter arising from the audit of the financial statements that (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, the auditor must document whether or not the matter was determined to be a CAM (i.e., involved especially challenging, subjective or complex auditor judgment) and the basis for such determination.

Other Requirements

The new rules make other changes to the form and substance of the auditor's report to clarify the auditor's role and responsibilities, provide additional information about the auditor and make the report easier to read. These changes include:

- a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;

- a statement regarding the requirement that the auditor be independent;
- that the report must be addressed to the company's shareholders and board of directors or equivalents (additional addressees are permitted);
- modifications to certain standardized language, 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 misstatement; and
- changes to the form of report, requiring a standardized form in which the auditor's opinion appears in the first section and the addition of section headings.

Implementation/Applicability

The new rules, other than those relating to CAMs, will be applicable to audits of fiscal years ending on or after December 15, 2017. The rules requiring disclosure of CAMs will apply to:

- audits of large accelerated filers for fiscal years ending on or after June 30, 2019; and
- audits of all other covered companies for fiscal years ending on or after December 15, 2020.

The disclosures regarding CAMs are not required for emerging growth companies, but the other requirements under the new rules apply.

Concerns and PCAOB and SEC Responses

The PCAOB in formulating and revising the proposal, and the SEC in approving the new standard, considered a range of concerns raised by commentators. Although many commentators applauded the changes for augmenting the information available to investors, concerns raised in comment letters received by the PCAOB and the SEC included:

- concerns that the new disclosure regarding CAMs would lead to additional boilerplate, rather than useful information, similar to the proliferation of risk factors in SEC filings;
- concerns that auditors could be required to disclose original issuer information, including potentially immaterial or confidential information, potentially confounding the role of the auditor;
- a possible "chilling" effect on communications between auditors and audit committees;
- increased liability and litigation risk for both auditors and companies; and
- additional economic and other burdens imposed on auditors and audit committees.

The PCAOB took into account this feedback during the formulation and approval of the new rules and modified the proposal to assuage these concerns. For example, the definition of CAM as initially proposed was narrowed to include a "materiality" qualification, and, in its release proposing the new rules, the PCAOB provided guidance regarding which matters would qualify as CAMs. SEC Chairman Jay Clayton has stated that the SEC is sensitive to the concerns it received throughout the comment process and stressed that the PCAOB should conduct a post-implementation review of the new standard to safeguard against unintended consequences.[3] The PCAOB and the SEC appear determined to ensure that the new rules effectively supplement disclosures with information useful to investors without harming auditor-audit committee communications or relationships.

If you have any questions regarding this client alert, please contact the following attorney or the attorney with whom you regularly work.

Jeffrey S. Hochman
212 728 8592
jhochman@willkie.com

[3] See the SEC's Public Statement, *Statement on SEC Approval of the PCAOB's New Auditor's Reporting Standard*, available here.