Skadden

SEC Reporting & Compliance Alert

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Accounting Oversight Board Adopts New Model for Auditor Reports

On June 1, 2017, the Public Company Accounting Oversight Board (PCAOB) adopted changes to its rules governing the content and organization of auditor reports required to accompany audited financial statements in filings made with the U.S. Securities and Exchange Commission (SEC). Subject to SEC approval, the changes will be phased in over time beginning with audits for fiscal years ending on or after December 15, 2017.

While auditor reports will continue to include the traditional pass/fail opinion, new auditing standard AS 3101 and related amendments to existing standards will require, among other things, that auditors disclose "critical audit matters" from the current period audit and the auditor's tenure with the company in their auditor reports. Such changes are intended to provide more useful information to investors and to more closely align the PCAOB's rules with those of international standard-setters.

Communication of Critical Accounting Matters

The most significant part of the PCAOB's rulemaking is the requirement that auditors communicate in their reports any critical audit matters (CAMs) arising from the current period's financial statement audit or include a statement in their reports that there were no such matters.

CAM Definition. A CAM is defined as a matter communicated or required to be communicated to the audit committee that:

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

Auditors communicate with audit committees regarding a wide variety of topics. Those topics typically include, among others, 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.

Matters Involving Especially Challenging, Subjective or Complex Auditor Judgment. The new auditing standard establishes a principles-based approach for identifying the existence of CAMs. Determining whether a matter involved especially challenging, subjective or complex auditor judgment, for example, requires an auditor to take into account the following nonexclusive factors:

- the auditor's assessment of the risks of a 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.

Depending on the matter, an auditor's determination that a CAM existed might be based on one or more of these factors, other factors specific to the audit or a combination thereof.

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

Auditor Disclosure Regarding CAMs. If an auditor determines that a CAM arose from the current period's financial statement audit, the auditor will be required to communicate certain information in its report accompanying the audited financial statements. Such information includes:

- an identification of the CAM;
- a description of the principal considerations that led the auditor to determine that the matter constituted a CAM;
- a description of how the CAM was addressed in the audit; and
- a reference to the relevant financial statement accounts or disclosures.

CAMs that arose from a prior period audit (*e.g.*, during an earlier period presented in the financial statements) also may be covered in an auditor's report, but such disclosure is not required. Situations in which an auditor may elect to communicate CAMs relating to a prior period might include, for instance, when an auditor's report is dual-dated or when a predecessor auditor has been asked to reissue its report.

Audits of Certain Filers Exempted From CAM Requirements. The audits of certain filers are exempted from the requirement that CAMs be communicated. Exempted filers include emerging growth companies (EGCs); investment companies other than business development companies; brokers and dealers reporting pursuant to Rule 17a-5 under the Securities Exchange Act of 1934, as amended; and employee stock purchase, savings and similar plans. The audits of foreign private issuers and smaller reporting companies are not carved out from the new requirements.

Other Changes to Auditor Reports

The new standard requires a number of other changes to auditor reports intended to clarify the auditor's role and responsibilities related to the financial statements audit, provide additional information about the auditor and make the auditor reports easier to read. For instance, the new standard requires auditor reports to include:

- a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;
- a statement that the auditor is required to be independent;
- the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financials are free of material misstatements;
- titles for each section of the report;
- the pass/fail opinion as the first section of the report under the heading "Opinion on the Financial Statements," immediately followed by a section titled "Basis for Opinion"; and
- the company's shareholders and board of directors or equivalents as the report's addressees (additional addressees are permitted).

Transition Period

The new requirements are subject to approval by the SEC, which will include a public notice and comment period. If approved by the SEC, which is likely but not assured because of opposition from certain interested parties, the requirements will be phased in over a three-year period, as follows:

- All provisions other than those related to CAMs will apply to audits for fiscal years ending on or after December 15, 2017.

- Provisions related to CAMs:
  - for large accelerated filers — will apply to audits for fiscal years ending on or after June 30, 2019.
  - for all other nonexempted filers — will apply to audits for fiscal years ending on or after December 15, 2020.

Auditors will be permitted to comply before the effective date, following SEC approval of the final standard.

Next Steps

In preparation for the CAM-related provisions, audit committees should establish with their auditors a process for receiving timely notification of any intention to disclose a CAM and the information that the auditor intends to include in its report about the matter. Audit committees also should be mindful that voluntary as well as required disclosure of material matters by the auditor to the audit committee requires the auditor to determine and document whether such matters constitute CAMs and, if so, to describe those matters in its report. Significant topics covered in any discussions with the auditor may provide an early indication of matters that ultimately could be publicly disclosed in an auditor's report.

Of the remaining changes adopted by the PCAOB, mandatory disclosure of auditor tenure is likely to receive the most attention. If the SEC approves the PCAOB's changes, disclosure of auditor tenure will be required in reports covering audits for fiscal years ending on or after December 15, 2017. In anticipation of those disclosures, audit committees of companies with long-tenured auditors should consider enhancing their audit committee reports to explain the benefits of maintaining a long-term relationship with their auditors, such as greater institutional knowledge, higher quality audits and fee efficiency, and describing the controls in place to ensure auditor independence.

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For additional information concerning the rule changes discussed in this alert, please see a copy of the PCAOB's adopting release.

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