New Requirements for Public Company Auditor's Reports

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Securities and Capital Markets

On October 23, 2017, the Securities and Exchange Commission (the "SEC") issued an order[1] granting approval of a proposal by the Public Company Accounting Oversight Board (the "PCAOB") to adopt Auditing Standard ("AS") 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*,[2] and related amendments to other auditing standards (collectively, the "Updated Standards"). The Updated Standards aim to make auditor's reports more informative and relevant to shareholders and investors and will result in significant changes to auditors' reports beginning with audits of fiscal years ending on or after December 15, 2017.

Overview

The SEC's order marks the end of a years-long process by the PCAOB to develop the Updated Standards in response to investor sentiment that more transparency and specificity of the basis for an auditor's opinion were needed.

The most significant change in the Updated Standards is a requirement that auditors now provide detailed disclosure and analysis of so-called Critical Audit Matters ("CAMs") in the auditor's report. A CAM is defined as any matter arising from the audit that (i) was required to be or actually was communicated to the audit committee; (ii) related to accounts or disclosures that are material to the financial statements; and (iii) involved especially challenging, subjective, or complex auditor judgment. The Updated Standards also include requirements to disclose auditor tenure and independence in the auditor's report, a requirement to present draft reports to audit committees for discussion, and conforming amendments to other PCAOB Standards to align with the new AS 3101.

The Updated Standards apply to all audits performed under PCAOB standards but do not require communication of CAMs in audit reports of emerging growth companies ("EGCs"); brokers and dealers reporting under Securities Exchange Act of 1934 (the "Exchange Act") Rule

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[1] SEC Rel. No. 34-81916 (Oct. 23, 2017), which can be found at https://www.sec.gov/rules/pcaob/2017/34-81916.pdf [the "SEC Release"].

[2] The new AS 3101 replaces portions of the existing AS 3101 and re-designates the remaining portions of AS 3101 as AS 3105.

17a-5; investment companies other than business development companies; and employee stock purchase, savings, and similar plans.

The Updated Standards, other than with respect to CAMs, become effective for audits of fiscal years ending on or after December 15, 2017. The Updated Standards pertaining to CAMs will go into effect for audits of fiscal years ending on or after June 30, 2019 for large accelerated filers[3] and for audits of fiscal years ending on or after December 15, 2020 for all other issuers.

Immediate Changes to the Auditor's Report

Several changes to the auditor's report will go into effect for audits of calendar year 2017. Procedurally, the Updated Standards now require the auditor to provide the audit committee with a draft report and for the auditor and audit committee to discuss that draft. In addition, the auditor's report must now contain statements disclosing the year in which the auditor began serving consecutively as the company's auditor and the requirement for the auditor to be independent. AS 3101 also amends certain standardized language as well as the form and organization of the auditor's report. The auditor's report must also now be addressed to the company's board of directors and its shareholders.

CAMs

CAM Analysis and Disclosure Requirements

The most significant change introduced by the Updated Standards requires communication of CAMs in the auditor's reports of many reporting companies. Under the revised AS 3101, a CAM is defined as any matter arising from the audit that (i) was required to be or actually was communicated to the audit committee; (ii) related to accounts or disclosures that are material to the financial statements; and (iii) involved especially challenging, subjective, or complex auditor judgment. Whether a matter meets the auditor judgment test in the definition will depend on the facts specific to the audit. To that end, the Updated Standards require the auditor to assess:

- 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;

[3] *See* Exchange Act Rule 12b-2(2) (defining a "large accelerated filer" as an issuer filing for at least one year with a public float of $700 million or more).

- 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.

This list is nonexclusive and auditors should take into account other factors specific to the audit to determine whether a matter meets the definition of a CAM.

For every matter arising from the audit that was communicated or required to be communicated to the audit committee and related to accounts or disclosures material to the financial statements, the auditor must document whether or not the matter was determined to be a CAM and how the auditor arrived at that determination. Thus, even if a matter meeting prongs (i) and (ii) of the definition of a CAM is ultimately determined not to involve "especially challenging, subjective, or complex auditor judgment," the auditor must include in the auditor's report an analysis of the above factors, and any other factors the auditor deemed relevant, in concluding that the particular matter is not a CAM.

Auditors must communicate every CAM in the report. To achieve required "communication," the description of a CAM must identify the CAM; describe the principal considerations in determining that the matter was a CAM; describe how the CAM was addressed in the audit; and refer to the relevant financial statement accounts or disclosures.

SEC Analysis of Comments Related to CAMs

Throughout the PCAOB and SEC comment periods, supporters of the Updated Standards expressed the view that increased explanatory disclosure from auditors would make the auditor's report more useful by enriching the "mix of information" that investors evaluate on a routine basis and giving investors a window into auditors' processes for making challenging, subjective, and complex judgments. These supporters argued that the CAM requirements would thereby increase transparency and credibility of the auditor reporting process.

Opponents of the increased auditor analysis and disclosure requirements expressed concerns about the usefulness of CAM disclosures as compared to the potential unintended consequences, including (i) encouraging duplicative, conflicting, or boilerplate disclosure; (ii) chilling communications between auditors and the audit committee; and (iii) forcing auditors to become an original source for disclosure about public companies. In analyzing public comments, the SEC made it clear that it favors increased auditor disclosure in this context and believes that, on balance, the increased transparency required by the Updated Standards outweighs the concerns regarding disclosure usefulness and unintended adverse consequences.

Practice Points

We think the Updated Standards suggest some immediate practice points for public companies and auditing firms set out below. In addition, EGCs that expect to lose EGC status in the coming years should familiarize themselves with the requirements of the Updated Standards and consider the same practice points when the time comes.

Upcoming Audits of the Current Fiscal Year

- Auditor's reports for audits of fiscal years ending on or after December 15, 2017 are required, among other changes described above, to include disclosure of auditor tenure. As a result of this new requirement, auditors and companies may want to review current auditor rotation policies and procedures, as well as the communications regarding auditor independence.
- Audit teams should begin adjusting timelines to ensure that the substantive and procedural requirements of the Updated Standards do not result in unnecessary time crunches or missed deadlines.

Preparation for CAM Disclosures and Other Longer-Term Considerations

- Despite the delayed effective dates for required CAMs disclosures, audit committees and auditing firms should begin an ongoing dialogue about matters that would constitute CAMs now and begin developing an overall philosophy around the identification and disclosure of CAMs.
  - Internal and external auditing procedures may need to be revised to better align those procedures with the CAM requirements in the Updated Standards.
  - Auditors may want to assess in tandem with companies what factors will be used in their CAM identification process, including any unique aspects of a company's business that may affect that analysis.
  - In light of both company and auditor concerns around potential disclosure liability, companies may want to consider reviewing drafts of CAM disclosures with their auditors before the CAM disclosure requirements go into effect.
  - Representatives from a company's audit committee and disclosure committee should meet to develop a clear understanding of the potential ramifications of the CAM disclosure requirements. This might result in new procedures to ensure timely review of proposed CAM disclosures, particularly as related to other proposed disclosures of the company.
- Public companies should begin budgeting for what likely will be increased audit fees once compliance CAM disclosures are required.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Securities and Capital Markets practice:

David Martin	+1 202 662 5128	dmartin@cov.com
Brian Rosenzweig	+1 212 841 1108	brosenzweig@cov.com

This alert was prepared with assistance by Brianna Bloodgood, Law Clerk, not admitted to practice.