

June 9, 2017

PCAOB Adopts New Audit Standard Requiring Disclosure of Critical Audit Matters

On June 1, 2017, after several years of consideration, the Public Company Accounting Oversight Board (the “PCAOB”) unanimously adopted a new audit standard, AS 3101, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (available [here](#)), intended to enhance the relevance and usefulness of the auditor’s report by providing additional information to investors. The new audit standard is subject to approval by the Securities and Exchange Commission (the “SEC”).

The new standard and related amendments require auditors to include in the auditor’s report a discussion of critical audit matters—namely, matters that (i) have been (or are required to be) communicated to the audit committee, (ii) are related to accounts or disclosures that are material to the financial statements and (iii) involved especially challenging, subjective or complex auditor judgment. Under the new standard, the auditor’s report will also be required to disclose, among other things, the tenure of the auditor, including the year in which the auditor began serving consecutively as the company’s auditor, and certain other information described below.

In recent years, audit standards have been similarly updated to address critical audit matters by a number of organizations outside of the United States, including the International Auditing and Assurance Standards Board, the European Union and the Financial Reporting Council in the United Kingdom.

Background

Substantially unchanged for more than seventy years, the auditor’s report conveys limited information regarding the findings of the audit process. Its principal function is to offer a pass/fail verdict as to whether a company’s financial information is “fairly presented.” The PCAOB has acknowledged that the auditor’s report, as currently presented, does little to address the information asymmetry between investors and auditors, who have special insight into the judgments involved in the presentation of a company’s financial information. Various market participants have requested that the auditor’s report be updated to include additional information raised as part of the audit process that could assist in a more thorough evaluation of the quality of the financial information provided by the audited entity.

In June 2011, the PCAOB issued a concept release (available [here](#)) seeking public comment on potential changes to the auditor’s reporting model. In August 2013, the PCAOB proposed a new standard on the

matter (available [here](#)), and re-proposed the standard in May 2016 for additional public comment (available [here](#)).

New Auditing Standard

The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the auditor's report.

Critical Audit Matters. Substantially as re-proposed in 2016, the new standard requires the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit of the financial statements, or state that the auditor determined that there were no such critical audit matters. A critical audit matter is defined as 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.

The purpose of the requirement is to elicit disclosure about audit matters involving, among other things, significant management judgment, significant risk and significant changes to financial statement presentation.

Under the new standard, identification of a critical audit matter is a principles-based inquiry. In determining whether a matter involved especially challenging, subjective or complex auditor judgment, the auditor must take into account, alone or in combination, certain factors, including but not limited to:

- 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.

Notably, communications between the audit committee and the auditor not required to be made under PCAOB rules could also be a source of critical audit matters. Numerous commentators had objected to this provision during the comment process, arguing that the requirement could chill discussions between the audit committee and the auditors. Critical audit matters may also be drawn from matters required to be communicated to the audit committee, even if not actually communicated.

Once identified, the communication of each critical audit matter in the auditor's report must include:

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

The documentation of critical audit matters requires that for each matter arising from the audit of the financial statements that (a) was communicated or required to be communicated to the audit committee, and (b) relates to accounts or disclosures that are material to the financial statements, the auditor document whether or not the matter was determined to be a critical audit measure (*i.e.*, involved especially challenging, subjective or complex auditor judgment) and the basis for such determination.

Additional Requirements for the Auditor's Report. The new standard also includes a number of other requirements for the auditor's report that are primarily intended to clarify the auditor's role and responsibilities related to the audit, provide additional information about the auditor, and make the auditor's report easier to read, namely:

- **Auditor Tenure.** The auditor's report will be required to include a statement disclosing the year in which the auditor began serving consecutively as the company's auditor. In May 2016, the PCAOB issued a new rule requiring the audit firm to identify the name of the audit partner and other firms that participated in the audit.
- **Independence.** The auditor's report will be required to include a statement that the auditor is required to be independent.
- **Enhancements to Basic Elements.** Certain standardized language in the auditor's report has been changed, 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 misstatements.

- **Standardized Form of the Auditor's Report.** The opinion will appear in the first section of the auditor's report. Section titles have been added to guide the reader of the report.
- **Addressees.** The auditor's report will be addressed to the company's shareholders and board of directors or equivalent body (additional addressees also are permitted).

The final standard applies to audits conducted under PCAOB standards. Communication of critical audit matters is not required for audits of brokers and dealers, investment companies other than business development companies, employee stock purchase, savings, and similar plans, and emerging growth companies although they may voluntarily choose to do so. The other elements of the new auditing standard apply to these entities.

Effective Dates

The PCAOB is adopting a phased approach to the effective dates for the new requirements in order to provide accounting firms, companies, and audit committees more time to prepare for implementation of the critical audit matter requirements, which are expected to require more effort to implement than the additional improvements to the auditor's report. Subject to approval by the SEC, the new standard and amendments will take effect as follows:

- All provisions, other than those related to critical audit matters, will take effect for audits for fiscal years ending on or after December 15, 2017; and
- Provisions related to critical audit matters will take effect for audits for fiscal years ending on or after June 30, 2019, for large accelerated filers, and for fiscal years ending on or after December 15, 2020 for all other companies to which the requirements apply. This means that a fiscal year-end large accelerated filer may first have critical audit matters included in the auditor report filed with the annual report for the year ended December 31, 2019.

Auditors may elect to comply before the effective date at any point after SEC approval of the final standard.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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