SEC Approves Changes to Auditor's Reporting Standards

The Securities and Exchange Commission ("SEC") recently approved new rules and standards proposed by the Public Company Accounting Oversight Board (the "PCAOB") that require, among other things, the communication of critical audit matters ("CAMs") in most public company audit reports.[1]

I. Background

The PCAOB's proposal, filed with the SEC in July 2017,[2] is its fourth attempt to require auditors to provide additional information in audit reports that the PCAOB believes would enhance the value and relevance of audits and make them more useful to investors and other financial statement-users in assessing a company's financial reporting. After commenters raised significant concerns following the initial concept release in June 2011, the PCAOB again requested comment in August 2013 and once more in May 2016.[3]

II. Communication of Critical Accounting Matters

The new rules require that auditors of most public companies[4] communicate in their audit report any CAMs arising from the current period's audit, or state that no CAMs exist. To be considered a CAM, the matter must have arisen from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. For each matter that meets prong (1), the auditor must document whether or not the matter was determined to be a CAM and the basis for that determination.

In determining whether a matter meets the criteria of prong (2), the auditor should take into account various 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 audit effort required to address the matter, including the extent of specialized

---

[1] *See* SEC Release No. 34-81916 (October 23, 2017), *available at* https://www.sec.gov/rules/pcaob/2017/34-81916.pdf.

[2] *See* SEC Release No. 34-81187 (July 21, 2017), *available at* https://www.sec.gov/rules/pcaob/2017/34-81187.pdf.

[3] *See* PCAOB Release No. 2011-003 (June 21, 2011), *available at* https://pcaobus.org/Rulemaking/Docket034/Concept_Release.pdf; *See also* PCAOB Release No. 2013-005 (Aug. 13, 2013), available at https://pcaobus.org/Rulemaking/Docket034/Release_2013-005_ARM.pdf; *See also* PCAOB Release No. 2016-003 (May 11, 2016), *available at* https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf.

[4] The communication of CAMs in the auditor's report is not required for audits of emerging growth companies ("EGCs"), broker-dealers reporting under Exchange Act Rule 17a-5 (unless the broker or dealer is an issuer), investment companies other than business development companies and employee stock purchase, savings and similar plans. However, all other rules in the Approval Order apply for all audits performed under PCAOB standards.

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.

If a CAM is identified, the auditor must include the following within the audit report: (1) identify the CAM, (2) describe the principal considerations that led the auditor to determine that the matter is a CAM, (3) describe how the CAM was addressed in the audit, and (4) refer to the relevant financial statement accounts or disclosures.[5]

III. Other Highlights

In addition to the requirement to communicate CAMs, the new rules require other changes to the auditor's report, including:

(i) Adding a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;
(ii) Adding a statement regarding the requirement for the auditor to be independent;
(iii) Addressing the auditor's report to the company's shareholders and board of directors (or equivalents) (the auditor may add other addressees as well);
(iv) Making changes to certain standardized language in the auditor's report, 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; and
(v) Placing the opinion in the first section of the auditor's report and adding section titles.

The changes in this section apply to all audits performed under PCAOB standards, including audits of EGCs.

The Approval Order also approved several technical amendments to other PCAOB standards, including amending the required order of the auditor's report, requiring the auditor to provide and discuss a draft of the auditor's report with the audit committee, and requiring the engagement quality reviewer to evaluate the engagement team's determination, communication, and documentation of CAMs.[6]

IV. Effectiveness

The changes described in Sections III and IV above will become effective for all audits for fiscal years ended on or after December 15, 2017. The changes described in Section II above relating to the reporting requirement of CAMs will become effective for all audits of large accelerated filers for fiscal years ending on or after June 30, 2019, and for all other filers for fiscal years ending on or after December 15, 2020.

[5] The PCAOB's 2017 proposal provides guidance that (1) the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, is not a CAM, (2) a potential illegal act, if an appropriate determination had been made that no disclosure of it was required in the financial statements, would not meet the definition of a CAM, and (3) a potential loss contingency that was communicated to the audit committee, but that was determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a CAM.

[6] *See supra* note 1, at 5, 6.

*   *   *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Kimberly Petillo-Décossard at 212.701.3265 or kpetillo-decossard@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Kaitlyn Pasco at 212.701.3859 or kpasco@cahill.com.