



THE NEW AUDIT REPORT

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Securities and Exchange Commission and Public Company Accounting Oversight Board

On October 23, 2017, the Securities and Exchange Commission (“SEC”) approved the new auditor reporting standard, as proposed by the Public Company Accounting Oversight Board (“PCAOB”). The final standard maintains the pass/fail opinion of the existing auditor’s report, but makes a number of significant changes including the introduction of critical audit matters (“CAM”).

Auditors will now be required to communicate in the auditor’s report any CAM arising from its audit or state that there were no CAMs.

The determination of a CAM is principles based, and is defined as a matter 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. Involves especially challenging, subjective, or complex auditor judgment

Beyond the introduction of the CAM, the new auditor’s report makes several other changes including required statements concerning auditor tenure, independence, the nature of the audit, and others.

The New Audit Report

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In adopting the standard, the PCAOB’s goal is to make the auditor’s report more relevant to investors by requiring the inclusion of additional and specific details about the audit.

With no significant changes to the standard form of the audit report in over 70 years, it is not a surprise that its form and content was evaluated to see how it could be enhanced. Today, auditor’s reports are generally boilerplate, and follow strict standards over form and content. In developing the new standard, the PCAOB solicited feedback on various drafts, receiving over 400 comments from industry, accounting firms, investors, analysts, and professional organizations. Although the feedback was mixed, there were some potentially significant concerns raised by commenters, including disclosure of previously unreleased information, increased time and expense, and impacts to auditor and issuer liability.

While the new auditor’s report is intended to increase relevancy and transparency for investors, commenters have raised concerns the new requirements may result in a number of unintended consequences.

5 Potential Unintended Consequences of New Auditor Reporting Standard

- 1 Disclosure or inference of information not previously made public
- 2 Perception of heightened risk by users of financial statements
- 3 Reduced communication between audit committees and external auditors
- 4 Disputes regarding significance
- 5 Shift in auditors’ potential liability

1 Disclosure or inference of information not previously made public

Disclosure of information not previously made public or which provides an inference to circumstances not previously disclosed which could adversely impact a company from an operational perspective.

As an example, assume a public company manufactures products for a large retailer and is reliant on that retailer for a substantial portion of its business. The company's auditor spends a significant amount of effort evaluating whether a going concern is present, ultimately concluding a going concern opinion was not merited; however, under the new requirements, the auditor evaluates whether the assessment of the going concern should be documented as a CAM and concludes given the particular circumstances that it merits disclosure in the audit opinion. In fact, the PCAOB release states, "the auditor's evaluation of the company's ability to continue as a going concern could also represent a critical audit matter depending on the circumstances of a particular audit."¹

Now, consider a competitor using this information to disadvantage the company's future negotiations with its largest customer by suggesting to the retailer that the auditor's opinion highlights previously undisclosed risk and that the retailer should consider alternative sources to reduce perceived supply risk. The previously undisclosed information could directly impact the company's operations, by influencing its largest customer's decision making.

¹PCAOB Release No. 2017-001



2 Perception of heightened risk by users of financial statements

CAMs may lead to the release of previously undisclosed facts and circumstances related to an issuer's financial reporting processes. This additional disclosure may lead to a perception of heightened risk, additional pressure on internal controls, or a need for additional oversight for CAMs.

Assume an international manufacturing company has significant operations across the globe. As part of its close process for financial reporting, the company undergoes a complex financial statement consolidation, whereby data is received from numerous subsidiaries and is processed through a complex consolidation by the parent entity. Many of the subsidiaries operate on unique or independent ERP systems. This is an outcome of a significant portion of the company's operations having been acquired over many years, and operated on platforms that do not directly interface with each other. As such, the financial statement consolidation performed at the parent is predominantly a manual process and lacks meaningful automation or system-level controls. Based on the preceding facts, the company's auditors have determined that the consolidation process is a CAM, as it requires significantly more effort to audit this area, including the manual

tracking and adjustments for intercompany and foreign exchange impacts. The extent of these efforts necessitated a discussion with the audit committee.

While the above scenario is not an uncommon situation for both management and auditors, it would be unusual for such facts and circumstances to be publicly disclosed.

The disclosure of this previously undisclosed information could possibly lead to questions, including:

- Is the company's process inherently flawed or deficient?
- A view that consolidations in general represent a bookkeeping exercise, so exactly what warranted disclosure as a CAM?
- Why don't other industry peers have a similar CAM disclosure? Is this indicative of a competitive disadvantage?
- Could this imply the company may undergo effort to standardize systems or implement additional internal controls to refine its process?
- Is the company not integrating the bookkeeping among separate operations because it is contemplating divestitures in the future?
- Do analysts discount the company's stock value due to the perception that its information systems and capabilities may be less robust than its competitors?

While many of these are not questions you would typically expect to hear on an investor call, this is also possibly not information that has been previously available or disclosed to investors. The PCAOB release indicates "the standard provides that even when management has not disclosed information, the auditor is not constrained from providing such information if it is necessary to

describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit."² Management may also receive questions from financial statement users on matters that are disclosed by auditors as CAMs, especially if their peers do not have similar CAMs.

COMMENT LETTER EXCERPT Large Financial Services Provider³

"Although the auditor is not expected to provide information about the company that has not been made publicly available by the company, such information may be provided by the auditor if necessary to describe the principal considerations used to determine that a matter is a CAM or how the CAM was addressed in the audit (e.g., information regarding information technology controls, or other information not currently required by GAAP or typically included in the financial statements). In the absence of appropriate context and two-way communication, we believe that such information potentially would be misleading, incomplete, and would not enhance the overall understanding of the readers of the auditor's report and financial statements."



² PCAOB Release No. 2017-001

³ Comment Letter #46 for PCAOB Docket 034

3 Reduced communication between audit committees and external auditors

The determination of CAMs may unintentionally result in reduced communication between audit committees and the external auditors.

With all matters communicated to the audit committee now serving as a population of potential CAMs, the lines of communication between audit committee and auditors may change. Audit committee members may be more reserved in the specific matters they discuss with auditors and defer to communicating with management on uncertain topics, so as not to unintentionally increase this population of potential CAMs and distract the auditor from the underlying audit that is of the utmost importance to most audit committees. The SEC has also acknowledged that, “there exists a risk that communications between the auditor and the audit committee could be chilled, if the auditor were to avoid raising certain issues to the audit committee’s attention so as to not trigger the requirement to determine whether such issues are CAMs.”⁴

There may also be a shift to audit committees preferring to interact indirectly with auditors, outside of required communications. Audit committees may begin to engage with management and internal audit first to ensure their communications with their auditors are reserved to only critical audit matters. As a result, internal audit may also be assigned additional responsibility in acting as a liaison between the audit committee and auditor for informative and less critical communications, redirecting internal audit from its other important activities.

⁴ SEC Release No. 34-81916

⁵ Comment Letter #54 for PCAOB Docket 034

COMMENT LETTER EXCERPT Audit Firm⁵

“Without limiting the source of potential CAMs to the communication requirements in AS 1301, a standard [The New Audit Report] risks creating a need for auditors to consider and document every communication with the audit committee, which we believe could result in less dialogue with the audit committee, which would not be in investors’ interests.”



4 Disputes regarding significance

Reaching agreement on what accounts and financial statement captions are material and judgmental will take on new importance among management and their auditors.

Defining CAMs is likely to become a source of some tension between management and auditors, given the implications and impacts discussed above.

Auditors and management will inevitably have time-consuming debates over which accounts or disclosures should be considered “material.” The

determination of materiality can be a subjective and evolving exercise. How an auditor and management define account level detail can differ and evolve, and the new CAM disclosures by the auditor will likely place more importance on management and their auditors developing an upfront understanding on materiality to prevent surprises and disputes regarding the ultimate CAM disclosures.

Similarly, the distinction of how complex, judgmental or challenging an account or disclosure is may depend on whether it is seen through the lens of management or the auditor. Management may disagree with the auditor on the complexity of an account, and may even take issue with the manner in which the auditor is testing the account. Management may ask the following question of its auditor: is the account inherently complex and challenging, or is it possible that the design of the audit procedures can be improved to reduce perceived risks?



5 Shift in auditors' potential liability

The inclusion of CAMs may change auditors' potential liability under securities law, imposing additional liability not previously observed.

Liability may be imposed on auditors under a number of different legal theories depending on the specific facts and circumstances of a case, including pursuant to the Securities Act of 1933, the Securities Exchange Act of 1934 and various state laws. Further, some believe investors who suffer a financial loss could assert legal claims against the auditor based on statements made in identifying and describing CAMs, or based on the lack of such statements. In their comment letters regarding the new audit opinion requirements, certain respondents raised concerns that additional disclosures may lead plaintiffs to view the audit opinion as an additional source of support for litigation. The SEC has also acknowledged the possibility of such an outcome, reflecting that, "we recognize reporting of CAMs likely will create an incremental risk of litigation and potential liability."⁶ The addition of CAMs introduces more information to the audit opinion that may serve as ammunition to bring unsubstantiated actions.

COMMENT LETTER EXCERPT Audit Firm⁷

"[A]uditor liability concerns should be recognized as the Board moves forward with finalizing the standard. As discussed in our previous comment letter, the repropose new auditor statements — with respect to CAMs — could lead to new claims under Section 10(b) of the Exchange Act, Section 11 of the Securities Act of 1933, and various state laws."

⁶ SEC Release No. 34-81916

⁷ Comment Letter #41 for PCAOB Docket 034

The preceding concerns appear to be shared by a broad group of professionals and practitioners, including the SEC, which has highlighted that the implementation of this new requirement needs to be carefully monitored by all. Specifically, SEC Chairman Jay Clayton summarized:



“I would be disappointed if the new audit reporting standard, which has the potential to provide investors with meaningful incremental information, instead resulted in frivolous litigation costs, defensive, lawyer-driven auditor communications, or antagonistic auditor-audit committee relationships — with Main Street investors ending up in a worse position than they were before.

I therefore urge all involved in the implementation of the revised auditing standards, including the Commission and the PCAOB, to pay close attention to these issues going forward, including carefully reading the guidance provided in the approval order and the PCAOB's adopting release.

In this vein, I am also pleased the PCAOB intends to monitor the results of implementation, including consideration of any unintended consequences.”⁸

– Jay Clayton, SEC Chairman

⁸ October 23, 2017 Statement on SEC Approval of the PCAOB's New Auditor's Reporting Standard



Other Potential Considerations

The potential impacts of CAMs on the PCAOB inspection and SEC review processes.

The auditor may take a “catch-all” or “shotgun” approach in determining CAMs in an effort to reduce potential auditor liability.

CAMs may represent a regurgitation of risk factors and critical accounting policies already disclosed by management, resulting in boilerplate language and adding further duplicity to the Form 10K.

The disclosure of audit tenure may result in a perceived correlation between audit tenure and audit quality.

Conclusion

The PCAOB’s goal to increase relevancy and transparency for financial statement users via revisions to the auditor’s report is an honorable endeavor with potential positive benefits. However, as with other new rules, there are potential unintended consequences. Ultimately, time will tell as to whether the new audit report in its current form fosters or dampens its usefulness to the public markets.

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