

SEC Approves PCAOB's New Rules on Auditor Reports

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The Securities and Exchange Commission has approved the Public Company Accounting Oversight Board's (PCAOB) proposed Auditing Standard 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses An Unqualified Opinion* (AS 3101) and related amendments to certain other auditing standards. The new rules implement various changes to the audit report model, including a requirement that auditors communicate "critical audit matters" in their audit reports. The rules are intended to provide new information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users.

The new requirements and their applicability and effective dates are described more fully below. The PCAOB adopted AS 3101 and the related amendments on June 1, 2017, subject to SEC approval. The PCAOB's adopting release, which includes the text of the new standard and related amendments as appendices, is available [here](#). The SEC approved the new rules on October 23, 2017, and its related order is available [here](#).

Communication of Critical Audit Matters

AS 3101 requires an auditor to identify and discuss in its audit report any "critical audit matters" (or CAMs) arising from the current period's audit or to state in its audit report that it has determined that there are no CAMs.

A CAM is defined as any matter arising from the audit of financial statements that:

- was communicated, or was required to be communicated, to the company's audit committee;
- relates to accounts or disclosures that are material to the financial statements; and
- involved especially challenging, subjective, or complex auditor judgment.

A matter must satisfy all of the foregoing criteria in order to constitute a CAM.

In its adopting release, the PCAOB indicated that CAMs are to be determined using a principles-based framework. Accordingly, AS 3101 does not specify any particular items that would constitute CAMs. Instead, the standard includes the following non-exclusive list of factors that should be taken into account, together with audit specific factors, when determining whether a

matter involved especially challenging, subjective or complex auditor judgment:

- the auditor’s assessment of the risks of material misstatement, including significant risks (*i.e.*, a risk of misstatement that requires special audit consideration);
- the degree of auditor subjectivity in determining or 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;
- 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; and
- the nature of audit evidence obtained regarding the matter.

In addition to identifying the CAM, the auditor’s report must:

- describe the principal considerations that led the auditor to conclude that the matter is a CAM;
- describe how the matter was addressed in the audit; and
- refer to the relevant financial statement accounts or disclosures that relate to the CAM.

The new standard does not specify the manner in which the audit report must describe how the matter was addressed in the audit, but it does include examples of potential approaches, which the PCAOB indicated were intended to clarify its expectations while providing flexibility in satisfying the requirement. Specifically, these examples suggest that the auditor may describe:

- the auditor’s response or approach that was most relevant to the matter;
- a brief overview of the procedures performed;
- an indication of the outcome of the auditor’s procedures;
- key observations with respect to the matter; or
- some combination of the foregoing elements.

The new standard notes that, “[w]hen describing critical audit matters in the auditor’s report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information 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.” The PCAOB’s adopting release elaborated on this issue, noting that it expects an auditor will not include previously undisclosed information in its audit report if it can adequately convey the required information without doing so, but that an auditor is not constrained from including such information if necessary to satisfy the requirements of the standard.

Other New Requirements

AS 3101 also makes several other changes to the auditor’s report, including revisions to certain standardized language and the standardized form of the auditor’s report and requirements that the report:

- include a statement regarding the auditor’s tenure (specifically, the year in which the auditor began serving consecutively as the company’s auditor);
- include a statement that the auditor is required to be independent; and
- be addressed to the company’s shareholders and board of directors.

Applicability and Effectiveness

The provisions of AS 3101 regarding communication of CAMs in the auditor’s report generally will apply to all audits conducted under PCAOB standards, except that they will not apply to audits of:

- emerging growth companies (as defined in the JOBS Act);
- brokers and dealers reporting under Exchange Act Rule 17a-5;
- investment companies other than business development companies; and
- employee stock purchase, savings and similar plans.

The provisions regarding communication of CAMs will take effect:

- for large accelerated filers, for audits of fiscal years ending on or after June 30, 2019; and
- for all other companies to which the provisions apply, for audits of fiscal years ending on or after December 15, 2020.

All provisions of the new and amended standards other than those related to communication of CAMs generally will apply to all audits conducted under PCAOB standards and will be effective for audits of fiscal years ending on or after December 15, 2017.