

PCAOB Adopts Requirement to Disclose Critical Audit Matters in Auditor Reports

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Dear Audit Committee Member:

Yesterday, the PCAOB decided to adopt a new auditor reporting standard that includes the communication of critical audit matters (CAMs). The rules are subject to approval by the SEC.

A lengthy runway is provided before full compliance is required. Provisions other than those related to CAMs will take effect for audits for fiscal years ending on or after December 15, 2017. If your company is a large accelerated filer, provisions related to CAMs will apply starting with the audits for fiscal years ending on or after June 30, 2019. This means that a fiscal year-end large accelerated filer may first have CAMs included in the auditor report filed with the Form 10-K for the year ended December 31, 2019.

For other companies, the rules on CAMs come into play beginning with audits covering fiscal years ending on or after December 15, 2020. Your auditor may, however, elect to comply early, before these deadlines. Emerging growth companies are exempt from the requirements.

Once the regulations are effective, your auditor's report must disclose whether any CAMs arose from the current period's audit, or state that there were none. A CAM is defined as a matter that was communicated or required to be communicated to you, the audit committee, and that (a) relates to accounts or disclosures that are material to the financial statements and (b) involve especially challenging, subjective or complex auditor judgment. When deciding whether a matter meets this criteria and warrants disclosure, the auditor is supposed to take into account certain factors, including the auditor's assessment of the risks of material misstatement.

You should be aware that CAMs are drawn from matters that are required to be communicated by the auditor (even if not communicated), or actually communicated (even if not required), to your committee. PCAOB standards require the auditor to communicate to your committee on significant risks identified by the auditor and significant unusual transactions. Your auditor must also discuss with you certain matters regarding your company's accounting policies, practices and estimates, related party transactions, and matters arising from the audit that are significant to the committee's oversight of your company's financial reporting process.

Other communications between your committee and the auditors, even if they were not required to be made under PCAOB rules, could also be a source of CAMs. During the proposal process, commenters had objected to the broad scope of the rules in covering these types of communications, concerned that they could chill discussions between you and the auditors. The PCAOB was not convinced. The regulator seems to believe that the broad scope of what is required to be communicated to you with respect to the committee's oversight responsibilities would likely include any matters identified as CAMs. The PCAOB also ignored suggestions that certain communications on sensitive topics, such as alternatives to GAAP or violations of law, independence concerns and disagreements with management, should be excluded from consideration as CAMs.

Once an auditor decides that a CAM needs to be included in the report, the auditor would: (a) identify the CAM; (b) describe the principal considerations that led the auditor to determine that the matter is a CAM; (c) describe how the CAM is addressed in the audit and (d) refer to the relevant financial statement accounts or disclosures.

The rule also made other changes to the report, including requiring disclosure of auditor tenure and auditor independence. The form of the report will also appear slightly different with the opinion in the first section, the addition of

section titles, and being addressed to shareholders and the board, along with any other additional addressees.

A copy of the adopting standards is linked [here](#) . Page 14 contains a helpful graphic chart on CAMs.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu

+1 212 450 4908

ning.chiu@davispolk.com

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