

SEC Approves PCAOB Rule Expanding Auditor's Report

October 25, 2017

On October 23, the SEC **approved** a new PCAOB **audit standard** that requires the auditor's report to identify and discuss critical audit matters (CAMs) encountered in the audit. The new standard also requires the auditor's report to include disclosure of auditor tenure, and revises the format and presentation of the report.

The new standard will require significant changes in practice for auditors, companies and their audit committees, and will likely impact the timetable that companies have previously employed to complete their audit and related disclosures.

Compliance with disclosure of auditor tenure and changes to format and presentation of audit reports is required for fiscal years ending on or after December 15, 2017 -- meaning that calendar year companies will be impacted with the next Form 10-K. The new CAM disclosure requirements apply to large accelerated filers beginning with fiscal years ending on or after June 30, 2019, and to others beginning with fiscal years ending on or after December 15, 2020. CAM disclosure applies to audit reports filed by foreign private issuers, but not to audit reports filed by emerging growth companies.

Changes to the Auditor's Report Format

Under the new standard, the audit report must state the year the audit firm began consecutively serving as the company's auditor. Auditor tenure will be calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure.

The standard moves the auditor's opinion paragraph on fair presentation to the lead section and includes section titles to improve readability. Revisions to the auditor's report include the addition of a statement that the auditor is required to be independent, the inclusion of shareholders and directors (or their equivalents, as well as any other addressee parties) as addressees and new standardized language about the role and responsibilities of the auditor.

Critical Audit Matters

Under the new standard, auditors are required to disclose CAMs in a new section of the audit report. A CAM is a matter communicated or required to be communicated to the audit committee that:

- relates to accounts or disclosures that are material to the financial statements; and
- involved "especially challenging, subjective, or complex auditor judgment."

Factors the auditors will use to determine if a matter is a CAM include, for example:

- the risk of material misstatement;
- the degree of auditor judgment related to areas in the financials where management exercised significant judgment or used estimates with significant measurement uncertainty;
- unusual transactions and the extent of audit effort and judgment related to them;
- the degree of auditor subjectivity in applying audit procedures to the matter in question;
- the nature and extent of audit effort required to address a matter, including bringing in others outside the engagement team (i.e., the auditor's national office); and
- the nature of the audit evidence obtained regarding the matter.

For each identified CAM, the auditors must describe the CAM, the principal considerations for designating it a CAM, how the CAM was addressed in the audit and the relevant financial statement accounts or disclosures impacted.

The PCAOB hopes to elicit audit-specific information related to the audit client rather than boilerplate discussion of general risks. The new standard explains that the description of CAMs should not include disclaiming, qualifying, restricting or minimizing language on the responsibilities of the auditors or the financial statement opinion or imply that a separate opinion is being provided on the CAMs or disclosures to which they relate.

Action Items

Companies should engage with their auditors now to discuss changes to the audit process required to implement the new standard, and to understand what the auditor may consider a CAM for the company. In the audit cycles prior to CAM effectiveness, companies and their audit committees may wish to consider asking their auditors for mock CAM disclosure and establish timetables for draft and final CAM disclosures.

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

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