CLEARY GOTTLIEB

ALERT MEMORANDUM

New PCAOB Standard Will Mean Big Changes in Audit Reports

June 2, 2017

On June 1, 2017, the U.S. Public Company Accounting Oversight Board (PCAOB) adopted a new standard that requires an auditor to include additional information in its report about the audit. One feature of the new standard – the requirement to discuss critical audit matters or CAMs – will lead to an important change in disclosures about the financial statements of U.S. public companies.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or any of our partners and counsel listed under Capital Markets or Corporate Governance in the "Our Practice" section of our website.

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

For decades now, audit reports have been highly standardized, using formulaic language that varies little from one year to the next or, for a given audit firm, from one company to another. The traditional approach has been referred to as the "pass/fail" model, because the only real function of the report is to communicate whether the financial statements pass the test of the audit process.

Since 2010, the PCAOB has been seeking to expand what auditors must say, on the grounds that auditors obtain and evaluate a great deal of information but communicate little or none of that to investors. Reducing the "information asymmetry" between investors and auditors will, as the PCAOB sees it, reduce the information asymmetry between investors and management as well. The Board first issued a concept release on the auditor's reporting model in June 2011, proposed a standard in August 2013, and reproposed a standard in May 2016. The final standard it has now adopted is very close to the 2016 reproposal. The standard is still subject to approval by the Securities and Exchange Commission (SEC), and according to press reports, the PCAOB delayed final adoption so incoming SEC Chair Jay Clayton could be briefed in advance.

The new standard retains the pass/fail approach but also requires the report to discuss critical audit matters arising from the audit. A CAM is defined as "any matter arising 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 identified CAM, the auditor must describe the principal considerations that led it to determine that the matter was a CAM, describe how the CAM was addressed in the audit, and refer to the relevant financial statement accounts or disclosures.

As a result, the audit report will contain a substantial discussion of the most sensitive issues relevant to the financial statements. Examples are readily available, because there are already broadly similar requirements under International Auditing Standards, European Union legislation and rules of the United Kingdom's Financial Reporting Council. Those who commented in opposition to the proposal, many of them reporting companies and audit committee members, pointed to a number of potential issues, including increased liability risks; the possibility of extensive but uninformative "boilerplate" disclosures; the misuse of auditor reporting to elicit additional, potentially sensitive original information about the company; and a potentially chilling impact on relations between companies, their auditors and their audit committees. Supporters of the expanded disclosures – including investor representatives and the largest auditing firms – argued that they will provide valuable insight into the specific issues pertinent to understanding a specific set of financial statements.

Required CAM disclosures will begin to appear in late 2019 and early 2020. Specifically, the requirements will take effect for fiscal years ending on or after June 30, 2019 for large accelerated filers and for fiscal years ending on or after December 15, 2020 for all other companies. They will not apply to audits of emerging growth companies.

The new standard also sets forth a number of less momentous changes intended to provide additional information about the auditor and to clarify its roles and responsibilities. These will take effect for audits for fiscal years ending on or after December 15, 2017.

If you would like to discuss the new standard in more detail, please call your regular firm contacts or any of our partners and counsel listed under Capital Markets or Corporate Governance in the "Our Practice" section of our website.

…

CLEARY GOTTLIEB