ALERT MEMORANDUM

SEC Approval of PCAOB Standard Sets Stage for Significant Changes in Audit Reports

November 6, 2017

On October 23, 2017, the Securities and Exchange Commission (SEC) approved the Public Company Accounting Oversight Board's (PCAOB) new audit standard, representing the culmination of the PCAOB's multi-year deliberative process of reconsidering the traditional approach to audit reports and resulting in significant changes to those reports. The SEC approved the new standard, which was adopted by the PCAOB on June 1, 2017, without modification.

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.

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The new standard retains the auditor's pass/fail opinion from the existing auditor's report, but expands the auditor's disclosures in a number of respects, the most significant of which is a requirement for the report to discuss critical audit matters (CAMs) 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.

The CAM requirements will apply to the audits of large accelerated filers for fiscal years ending on or after June 30, 2019, and to the audits of all other companies subject to the new standard for fiscal years ending on or after December 15, 2020. These requirements will apply to all registrants, including foreign private issuers, but pursuant to the Sarbanes-Oxley Act, as amended by the JOBS Act, the CAM disclosure requirements will not apply to emerging growth companies.

In addition to the requirement to address CAMs, the new standard includes a number of less momentous changes intended to clarify the auditor's role and responsibilities and make the audit report easier to read. These changes include the addition of a statement regarding auditor tenure and the auditor's independence, the requirement to address the report, at minimum, to the company's shareholders and board of directors, changes to certain basic elements of the report and a new standardized format. These additional changes are the first to take effect and will apply to audits of all registrants, including for emerging growth companies, for fiscal years ending on or after December 15, 2017. Accordingly, the required changes will begin to appear in the audit reports filed as part of the next annual report of many registrants.

In its release approving the new standard, the SEC acknowledged many of the concerns that had been raised by commenters throughout the rulemaking process, including: (1) the usefulness of the information in CAMs; (2) the auditor's role as the potential source of original information about the company in CAMs; (3) the potential impact of CAMs on the role of the audit committee and the communication among the audit committee, management and the auditor; and (4) the potential liability impact of CAMs.

In particular, in addressing the concern that the auditor could be a source of original information about the company, the SEC said it expected "communication of original information [to] be limited to rare circumstances." The SEC noted that commenters had identified only three examples of this concern and reiterated the PCAOB's guidance for each: (1) a significant deficiency in internal control over financial reporting, which would not, in and of itself, be a CAM, (2) a potential illegal act, which would not meet the definition of a CAM if an appropriate determination had been made that disclosure of the act was not required in the financial statements and (3) a potential loss contingency communicated to the audit committee, which, if determined to be remote and not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not constitute a CAM.

Ultimately, the SEC determined that the benefits to investors and other financial statement users of the new standard—namely providing insights into the audit from the auditor's perspective—outweighed the associated risks. The SEC did, however, acknowledge the potential unintended consequences of the new standard and express its expectation that the PCAOB would carefully monitor its implementation, as we and others urged in comments to the SEC on the proposed new standard.

In his statement on the SEC's approval of the new standard, Chairman Clayton emphasized the importance of a timely and effective post-implementation review (PIR) of the new standard, and to that end the SEC staff has been directed to support the PIR by the PCAOB. He also encouraged the PCAOB to take advantage of the staggered effective dates to evaluate the impact of the new standard on large accelerated filers, and potentially modify the standard and its effective date with respect to other companies in light of that evaluation.

If you would like to discuss the new standard in more detail, 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.

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