
SEC Approves Enhanced Auditor Reporting Model

OCTOBER 30, 2017

On October 23, 2017, the Securities and Exchange Commission [approved](#) the Public Company Accounting Oversight Board's revised auditing standard, AS 3101, governing the contents and form of the audit report. As [noted](#) by SEC Chairman Jay Clayton, the new auditing standard "requires significant enhancements to certain public company audit reports, including the communication of critical audit matters ('CAMs') and the disclosure of auditor tenure. These changes are intended to make the auditor's report more informative." The SEC approved the new auditing standard in the form approved by the PCAOB in June. ([See our June 2, 2017 post](#))

The most important change to the audit report is the requirement for the auditor to discuss CAMs. CAMs are defined as matters arising from the audit that were communicated or required to be communicated to the audit committee and that (a) relate to "accounts or disclosures that are material to the financial statements" and (b) involved "especially challenging, subjective, or complex auditor judgment." As stated by the PCAOB, CAMs disclosure is designed to provide investors and other financial statement users with the auditors' perspective on some of the most difficult judgments made during the audit.

The SEC received approximately 50 comment letters on the proposed auditing standard. The SEC's Release addresses many concerns raised by commenters, including the following with respect to CAMs:

- *Boilerplate Disclosure.* In response to concerns that the audit report will devolve into a recitation of "unnecessary CAMs or boilerplate CAMs," the SEC Release suggests that "the focus on auditor judgment in the definition of CAMs, along with the requirement to disclose *why* a matter is a CAM and how it was addressed, should mitigate the extent to which expanded auditor reporting could become standardized." In light of the number of elements that must be satisfied before a matter becomes a CAM, "[t]he communication of CAMS should not be numerous and boilerplate and will provide additional information about the audit—and from the auditor's own unique perspective—that will be useful to investors and other financial statement users in assessing a company's financial reporting and making capital allocation and voting decisions."
- *Original Information.* Some commenters expressed concern that the auditor could potentially disclose original information not included in the company's own disclosure,

including potentially material or confidential information. In response to such concerns, the SEC Release notes that the new auditing standard includes a materiality qualifier and notes that the new standard provides that “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 SEC Release goes on to note that “to the extent original information would need to be communicated in a CAM, we anticipate that the auditor, management, and the audit committee will engage in a dialogue about that communication.”

- *Audit Committee Communications.* Concerns were also raised regarding the potential chilling effect of CAM reporting on the audit committee’s role and on communications among the audit committee, the auditor and management. In particular, some commenters suggested that auditors might avoid raising issues with the audit committee so as not to trigger CAM reporting. Noting that the auditing standard regarding audit committee communications (AS 1301) requires auditors to communicate many matters to the audit committee, the SEC observed that it would be “highly unusual for a matter to meet the definition of a CAM and not be required to be communicated to the audit committee.” Further, the SEC Release notes that the new auditing standard is intended to supplement the role of the audit committee, concluding that the new standard is “unlikely to impact this relationship or the dialogue between audit committees and auditors, and may even encourage audit committees to engage more extensively with auditors given that there will be disclosures by the auditor about those aspects of the audit that constitute CAMs.”

With respect to the last concern, Mr. Clayton’s separate statement said, “The audit committee’s key role in the oversight of the audit and the auditor, and in the integrity of a company’s accounting and financial reporting processes, has significantly enhanced financial reporting quality. Impairing or otherwise negatively affecting the work of well-functioning audit committees could have significant adverse effects on investors.” He added that he “would be disappointed” if the new standard “resulted in frivolous litigation costs, defensive, lawyer-driven auditor communications, or antagonistic auditor-audit committee relationships—with Main Street investors ending up in a worse position than they were before.”

Mr. Clayton also urged those implementing the revised auditing standard to “pay close attention to these issues going forward, including carefully reading the guidance provided in the approval order and the PCAOB’s adopting release.” He emphasized that the PCAOB intends to monitor the results of implementation, including consideration of unintended consequences. The SEC staff has been directed to assist in this post-implementation review process.

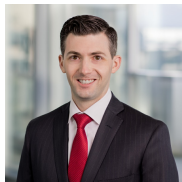
In addition to CAMs disclosure, the new auditing standard implements other changes to the audit report, including requiring disclosure of “the year in which the auditor began serving consecutively as the company’s auditor.” Some commenters opposed such disclosure altogether, while others suggested that disclosure in the audit report might give “undue prominence” to the information and could lead some to conclude that a correlation exists between auditor tenure and independence or audit quality. The SEC rejected these concerns, concluding that “it is appropriate for this disclosure

to appear in the auditor's report because it will provide for a consistent location and decrease search costs with respect to information about auditor tenure."

The new auditing standard will become effective in phases, with the changes other than CAMs disclosure being required in audit reports for audits of fiscal years ending on or after December 15, 2017. CAMs disclosure will first be included in audit reports for audits of large accelerated filers with fiscal years ending on or after June 30, 2019 (i.e., for calendar year companies, audit reports filed in 2020), and then for audits of all other companies to which the disclosure applies with respect to fiscal years ending on or after December 15, 2020 (i.e., audit reports filed in 2021). Notably, the new CAMs disclosure requirement is not required for audits of emerging growth companies and certain other companies, though the additional changes to the auditor's report will apply for all such audits.

While there is a long lead time before the CAMs requirement takes effect, companies and their audit committees should consider engaging with their auditors regarding how the auditors expect to implement the CAMs standard and how they expect to apply the standard in the particular circumstances of a company's audit.

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