

IN OUR OPINION

THE NEWSLETTER OF THE LEGAL OPINIONS COMMITTEE

ABA BUSINESS LAW SECTION

Volume 16 — Number 4

Summer 2017

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Will the PCAOB's New Audit Report Standard Affect Audit Letter Practice?

On June 1, 2017, after more than six years of discussion and proposals, the Public Company Accounting Oversight Board (“PCAOB”) approved a new auditing standard governing the form and contents of the audit report issued by a public reporting company’s independent registered public accounting firm.⁸ The new standard, AS 3101, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, changes the audit report in many respects. The most important change is a new requirement that the auditor discuss “critical audit matters” (“CAMs”). The auditor’s discussion of CAMs will supplement the audit report’s traditional “pass/fail” opinion as to whether or not an issuer’s financial statements fairly present, in all material respects, the company’s financial condition, results of operations and cash flows in accordance with generally accepted accounting standards in the United States. According to the PCAOB, its proposed CAMs disclosure “responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor’s expertise or mandate.”⁹

⁸ PCAOB Release No. 2017-001, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (June 1, 2017). The standards are subject to approval by the Securities and Exchange Commission. If approved, the “critical audit matters” (CAMs) provisions are intended to be effective for audits of large accelerated filers for fiscal years ending on or after June 30, 2019, and for other issuers for fiscal years ending on or after December 15, 2020. The CAMs requirements will not apply to audit reports for audits of emerging growth companies. The PCAOB’s other proposed auditor’s report changes are intended to be effective for audits of fiscal years ending on or after December 15, 2017.

⁹ PCAOB Release No. 2017-001 at 1.

A. Definition of a CAM; Application to Loss Contingencies

A CAM is defined as a matter arising from the financial statement audit “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.”¹⁰ For each CAM, the audit report must identify the CAM; describe the principal considerations that led the auditor to determine that the matter is a CAM; describe how the CAM was addressed in the audit; and refer to the relevant financial statement accounts or note disclosures that relate to the CAM.¹¹

Among other issues, the new standard raises questions about how it may apply to auditing of loss contingencies. Although the PCAOB does not discuss the matter in detail, it contemplates that a loss contingency could be a CAM. In discussing what types of matters would be covered by the standard, the PCAOB states:

“[A] matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter. For example, a potential loss contingency that was communicated to the audit committee, but that was determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a critical audit matter; it does not relate to an account or disclosure in the financial statements, even if it involved especially challenging auditor judgment.”¹²

¹⁰ PCAOB Release No. 2017-001 at A1-7 (amended AS 3101.11).

¹¹ PCAOB Release No. 2017-001 at A1-8, -9 (amended AS 3101.14).

¹² PCAOB Release No. 2017-001 at 20-21.

The implication of this statement is that a material loss contingency can be CAM if it involves a probability of an adverse outcome that is more than remote. Under Accounting Standards Codification Topic 450, *Contingencies*, where the probability of an adverse outcome is more than remote, the issuer must determine whether an accrual should be recognized and what disclosure may be required, whether or not there is an accrual. Determinations such as the probability of the outcome, whether the loss can be reasonably estimated and the amount of any such estimate can involve significant judgment by management. The line items to which the accrual is applied could be material. Questions about whether to disclose and the content of disclosures could also involve judgments as to content and materiality. It is not hard to imagine that in some circumstances the auditor may conclude that its audit of loss contingencies involved the kind of “especially challenging, subjective or complex auditor judgment” that triggers CAM disclosure.

B. Initial Observations

It is far too early to assess how AS 3101 will play out in practice as applied to loss contingencies, and dire predictions should be avoided. However, as with loss contingency disclosure generally, lawyers will need to be sensitive to the potential impact of the new standard on a client’s attorney-client privilege and on the client’s position in litigation.¹³

¹³ Several years ago, the legal profession and business community expressed concerns about the Financial Accounting Standards Board’s proposed amendments to the loss contingency disclosure requirements of Accounting Standards Codification Topic 450, *Contingencies*. These commenters were concerned that the proposed new disclosures regarding loss contingencies could have a prejudicial impact on companies’ litigation positions and raised risks for fundamental attorney-client privilege and work product protections. See, e.g., Letter from Stephen N. Zack, President, American Bar Association, to Russell G. Golden, Technical Director, Financial Accounting Standards Board (Sept. 20, 2010), available at

Below are some initial observations about aspects of the new standard that could have an impact on the relationship between lawyers and auditors in the audit process:

- AS 3101 does not change the auditing standards governing audit letters. AS 2505, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments*, continues to specify the procedures that the independent auditor should follow to identify legal contingencies and satisfy itself regarding the financial accounting and reporting for such matters. AS 3101 also does not change the lawyer’s responsibilities under the ABA *Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information* (the “ABA Statement”). There is little reason to think that AS 3101 will change practice with respect to most loss contingencies that are covered by AS 2505 — particularly, those that do not involve “especially challenging, subjective, or complex auditor judgment.”
- The possibility that an auditor will have to provide CAM disclosure about its audit judgments with respect to contingencies may cause the auditor to seek additional information from the company’s counsel (both in-house and outside) about the matter. This may especially be the case with contingencies that involve significant government investigations or complex, “bet-the-company” litigation. In recent years, there has been a trend toward auditors asking company counsel for additional information regarding significant loss contingencies, and that trend may expand if auditors frequently conclude that contingencies are or could

https://www.americanbar.org/content/dam/aba/migrated/pol_adv/letters/attyclient/2010sep20_fasb_c.authcheckdam.pdf. The FASB dropped this project in 2012.

be CAMs.¹⁴ In such cases, lawyers will have to be cognizant of the guidelines set forth in the ABA Statement for providing information to auditors and will need to focus closely on the privilege and disclosure implications of providing information to the auditors that goes beyond the information provided for by the ABA Statement.

- If an auditor concludes that a loss contingency is a CAM, that may raise questions about the appropriate content of disclosure about the CAM in the audit report. AS 3101 allows the auditor to disclose non-public information about the company if doing so “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.”¹⁵ This could lead to a concern that additional disclosures advanced by the auditor might include information — such as the nature and content of information obtained from the issuer’s lawyers about the contingency that is the subject of the CAM — that could prejudice the company’s litigation position or even raise concerns about waiver of privilege and attorney work product protections.
- In connection with the new reporting standard, the PCAOB also revised AS 1301, Communications with Audit

¹⁴ AS 2505.10 contemplates that “[i]n special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments.”

¹⁵ PCAOB Release No. 2017-001 at A1-9 (amended AS 3101.14, note 2).

Committees, to require the auditor to “provide to and discuss with the audit committee a draft of the auditor’s report.”¹⁶ This process can provide a means for companies and their counsel to work through any concerns about CAM disclosures related to loss contingency matters. Ultimately, however, the auditor alone has control over the content of its report.

- Finally, as contemplated by Paragraph 7 of the ABA Statement, most audit inquiry responses state that, without the written consent of the lawyer or firm, the response is not to be quoted or referred to in the financial statements, the notes thereto, or the auditor’s comments thereon, or in any communication to shareholders or other persons or in any filings with any governmental agency. Questions about the need for consent could arise when an auditor believes it is necessary to describe its communications with lawyers in a CAM disclosure.¹⁷

¹⁶ See PCAOB Release No. 2017-001 at A2-51 (amendment to AS 1301.21).

¹⁷ Paragraph 7 of the ABA Statement also provides that auditors may furnish the response to others “in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency,” provided the lawyer is given at least 20 days’ notice before the response is furnished, or as in advance as possible if the situation does not permit 20 days’ notice. The Commentary to Paragraph 7 explains that it is “designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor’s defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith.”

The foregoing considerations all indicate the value of timely discussions during the audit process between the auditors, in-house and outside lawyers and company management about any loss contingencies that might be candidates for CAM disclosure, as well as timely discussions among those persons about the content of any such disclosure prior to discussions about both matters with the audit committee. In addition, the potential impacts of the new audit report standard suggest that a dialogue between the legal and auditing professions may be worthwhile to address potential concerns before the CAM standard takes effect.

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LEGAL OPINION REPORTS

(See Chart of Published and Pending Reports on following page.)

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