

AN OFFERING FROM THE BDO CENTER FOR CORPORATE GOVERNANCE
AND FINANCIAL REPORTING

BDO FLASH REPORT

CORPORATE GOVERNANCE



SUBJECT

PCAOB ADOPTS NEW STANDARD TO ENHANCE THE AUDITOR'S REPORT; PROPOSES NEW STANDARD REGARDING AUDITING ACCOUNTING ESTIMATES; AND PROPOSES AMENDMENTS REGARDING AUDITOR'S USE OF SPECIALISTS

SUMMARY

On June 1, 2017 the Public Company Accounting Oversight Board (PCAOB) adopted a new auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments to certain other PCAOB standards, to enhance the auditor's report by requiring communication of additional information about the audit, including communication of critical audit matters.

The PCAOB also proposed for public comment a new auditing standard, *Auditing Accounting Estimates, Including Fair Value Measurements*, along with related amendments, to enhance the requirements applicable to auditing accounting estimates, including fair value measurements. In addition, the PCAOB proposed amendments to strengthen requirements regarding when auditors use the work of specialists in an audit.

The following summarizes the requirements included within the adopted standard, as well as the proposed standard and the proposed amendments.

DETAILS

Adopted AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Related Amendments

The new standard and related amendments retain the pass/fail opinion in the existing auditor's report, but significantly changes the existing auditor's report through the following requirements:

- ▶ The new standard requires the auditor to communicate in the auditor's report any critical audit matters (CAMs) arising from the audit, or state that the auditor determined that there were no CAMs. CAMs are matters that were communicated or required to be communicated to the audit committee, and that (1) relate to accounts or disclosures that are material to the financial statements, and (2) involve especially challenging, subjective, or complex auditor judgment.

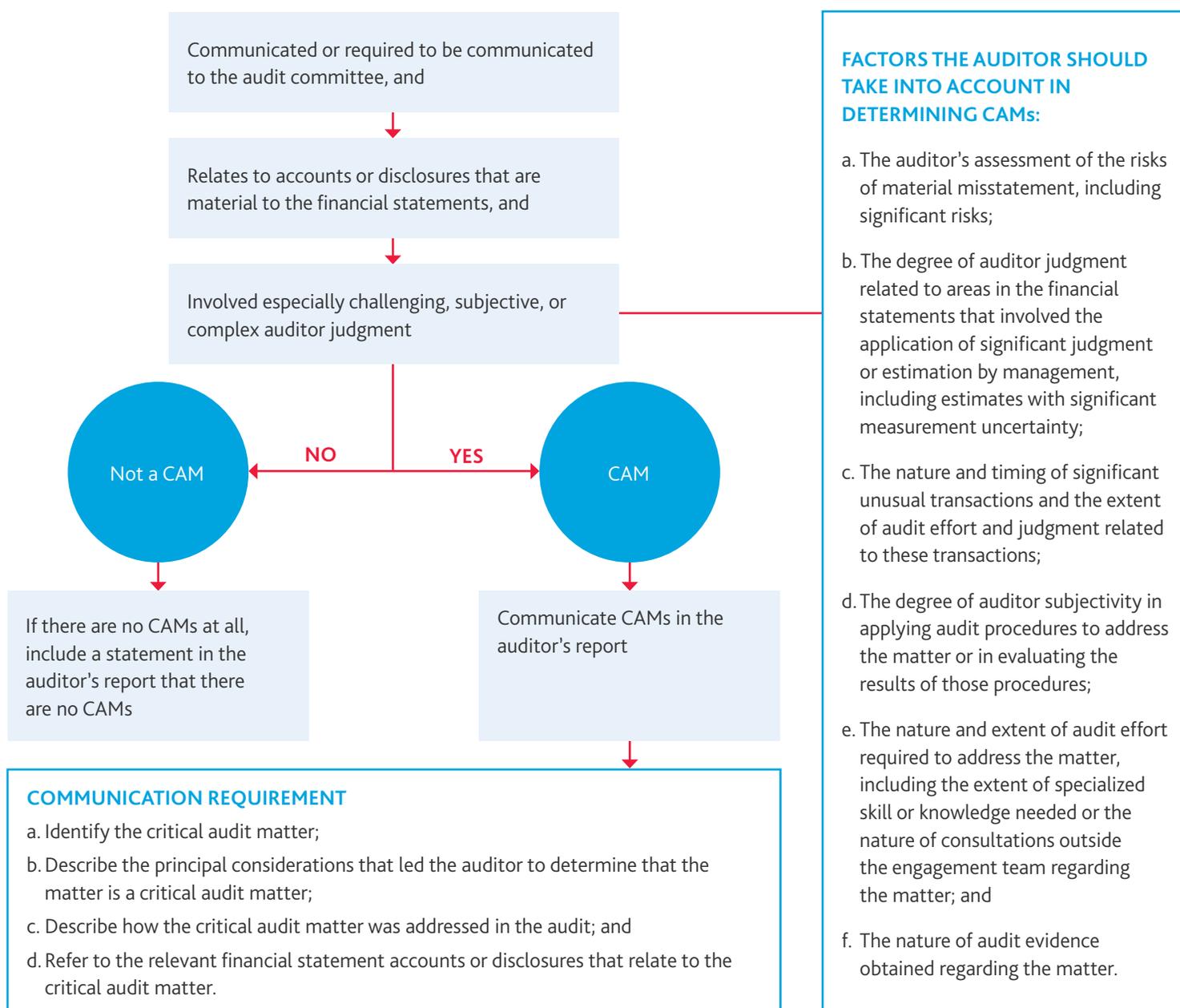
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- ▶ The auditor's report will include disclosure of the auditor's tenure, i.e., the year in which the auditor began serving consecutively as the company's auditor.
- ▶ The auditor's report will also include a statement that the auditor is required to be independent.
- ▶ The phrase, "whether due to error or fraud," will be included in the auditor's report in describing the auditor's responsibility under PCAOB standards to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements.
- ▶ The opinion will appear in the first section of the auditor's report, and section titles will be added to the report.

Figure 1. Determining and Communicating Critical Audit Matters ("CAMs")



- ▶ The auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted).

The communication of each CAM in the auditor's report will include:

- ▶ identification of the CAM;
- ▶ a description of the principal considerations that led the auditor to determine that the matter was a CAM;
- ▶ a description of how the CAM was addressed during the audit; and
- ▶ a reference to the applicable financial statement accounts or disclosures.

OBSERVATIONS

Source of CAMs: The source of CAMs will be drawn from matters required to be communicated to the audit committee, even if not actually communicated, and matters actually communicated (even if not required). As such, the first filter used to determine the population of possible CAMs recognizes the audit committee's oversight of the audit, such that the CAMs are to be drawn from matters communicated or required to be communicated to the audit committee. The second filter to be applied considers whether the accounts or disclosures are material to the financial statements or involve especially challenging, subjective or complex auditor judgment.

Materiality: The materiality component of the definition of CAMs pertains to accounts or disclosures that are material to the financial statements. The PCAOB concluded that the concept of materiality was essential to ensure the CAMs communicated were appropriately balanced such that the need to make the auditor's report more informative and useful for investors was not overshadowed by the inclusion of numerous immaterial matters that could cloud the importance of those items deemed to enhance the communicative value of the auditor's report.

"Relates to" clarifies that the CAM could be an element of an account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. The standard includes several examples of how this might apply:

- ▶ The auditor's evaluation of the company's goodwill impairment assessment could be a CAM if goodwill was material to the financial statements, even if there was no impairment; it would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company's impairment policy and goodwill.
- ▶ A CAM may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements or relate to many accounts or disclosures. E.g., the auditor's evaluation of the company's ability to continue as a going concern could also represent a CAM depending on the circumstances of a particular audit.
- ▶ A matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a CAM. E.g., 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 would not meet the definition of a CAM. Similarly, the determination that there is a significant deficiency (SD) in ICFR, in and of itself, cannot be a CAM. However, a SD could be among the principal considerations that led the auditor to determine that a matter is a CAM. The final standard indicates that while the auditor is required to describe the principle considerations that led the auditor to determine that the matter is a CAM and how the overall matter was addressed, it is not necessary for the auditor's description to use terminology from other auditing standards, such as "significant deficiency" within the broader context of a CAM.

CAM Determination: The determination of CAMs remains principles-based and the final standard does not specify any items that would always constitute CAMs. For example, all matters determined to be "significant risks" under PCAOB standards may not be determined to be CAMs. The auditor must determine, in the context of the specific audit, that a matter involved especially "challenging, subjective, or complex auditor judgment." Refer to factors outlined in Figure 1.

The final standard requires the auditor to communicate CAMs arising for only the current audit period, though the auditor would not be precluded from including CAMs for prior periods. The PCAOB indicates that it would expect that in most audits the auditor will determine that at least one matter would be considered a CAM. However, there may be circumstances whereby the auditor determines there are no CAMs to disclose in the current period. In this case, a statement to that effect must be included within the auditor's report.

Disclosure of How CAMs Were Addressed in the Audit: The final standard includes required introductory language to include within the auditor's opinion to refer to the communication of CAMs. Furthermore, the final standard does not prescribe an approach for the how an auditor is to describe within the auditor's report how the CAMs were addressed during the audit. This approach was meant to provide flexibility in how CAMs may be addressed by the auditor, bearing in mind the purpose of a CAM is to provide information about the audit of the company's financial statements that will be useful to investors and other stakeholders. In communicating CAMs, the auditor is not to imply that he/she is providing a separate opinion on them or on the accounts or disclosures to which they relate. It is also not appropriate for the auditor to use language that could call into question his/her opinion on the financial statements, taken as a whole. Additionally, when describing CAMs, 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 CAM or how the matter was addressed in the audit.

The standard indicates that the amount of documentation required in the auditor's report could vary significantly from audit to audit based on the circumstances specific to the audit. The auditor will further be required to provide a draft of the auditor's report to and discuss it with the audit committee prior to release of the auditor's report.

Auditor Tenure: Rather than including auditor tenure in the new PCAOB Form AP, the PCAOB is requiring auditors to include such information within the auditor's report since it is the primary vehicle by which the auditor communicates with investors. Inclusion of auditor tenure within the auditor's report is meant to provide investors with timely and readily available information. In response to concerns by commenters that communication of auditor tenure is more appropriately made as a form of a company disclosure, and should not be included within the auditor's report, the PCAOB acknowledged that the SEC may in the future determine that auditor tenure should be disclosed elsewhere in addition to or instead of in the auditor's report and at that time the PCAOB would work with the SEC to appropriately coordinate requirements.

EFFECTIVE DATE AND APPLICABILITY

The PCAOB adopted a phased approach to effectiveness for the new standard and amendments, to provide accounting firms, companies, and audit committees more time to prepare for implementation of the CAM requirements, which are expected to require more effort to implement than the other improvements to the auditor's report. Subject to approval by the SEC, the final standard and amendments will take effect as follows:

New Auditor Reporting Provisions	Effective Date
Report format, tenure, and other information	Audits for fiscal years ending on or after December 15, 2017
Communication of CAMs for audits of large accelerated filers	Audits for fiscal years ending on or after June 30, 2019
Communication of CAMs for audits of all other companies	Audits for fiscal years ending on or after December 15, 2020

The adopted standard generally applies to audits conducted under PCAOB standards; however, communication of CAMs is not required for audits of emerging growth companies; brokers and dealers; investment companies other than business development companies; and employee stock purchase, savings, and similar plans. Auditors of these entities may choose to voluntarily include CAMs in the audit report. However, the other requirements of the final standard will apply to these audits.

The PCAOB Release adopting AS 3101 and related amendments can be accessed [here](#).

Additionally, the PCAOB has developed a fact sheet on the adopted standard, which may be helpful in understanding the main provisions of the standard, accessible [here](#).

Proposed AS 2501, Auditing Accounting Estimates, Including Fair Value Measurements, and Related Amendments

This proposed standard replaces three existing auditing standards: AS 2501, Auditing Accounting Estimates, AS 2502, Auditing Fair Value Measurements and Disclosures, and AS 2503, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities. The proposed single standard also includes a special topics appendix that addresses auditing the fair value of financial instruments, including the use of information from pricing services.

The proposed single standard would strengthen existing requirements by:

- ▶ Prompting auditors to devote more attention to addressing potential management bias in accounting estimates, while emphasizing the importance of professional skepticism;
- ▶ Extending certain key requirements in the extant standard on auditing fair value measurements to all accounting estimates in significant accounts and disclosures, to reflect a uniform approach to substantive testing;
- ▶ Prompting auditors to focus on estimates with a greater risk of material misstatement;
- ▶ Providing specific requirements to address certain unique aspects of auditing fair values of financial instruments, including the use of pricing sources (e.g., pricing services and brokers or dealers); and
- ▶ Updating other requirements for auditing accounting estimates to provide clarity and specificity

The proposed standard can be accessed [here](#) and a fact sheet that summarizes the main provisions of the proposed standard can be accessed [here](#).

Comments regarding the proposed standard and related amendments to other PCAOB standards are due August 30, 2017 and may be submitted via the PCAOB's website, as indicated in the proposal document.

Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

These proposed amendments apply a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists, as well as strengthen requirements for evaluating the work of a company's specialist. Under this proposal, the PCAOB amends two extant standards: AS 1105, Audit Evidence, and AS 1201, Supervision of the Audit Engagement. AS 1105 would be amended to add a new appendix that addresses using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards. AS 1201 would be amended to add a new appendix on supervising the work of auditor-employed specialists. The proposal also would replace extant AS 1210, Using the Work of a Specialist, and retitle it to Using the Work of an Auditor-Engaged Specialist, to set forth requirements for using the work of auditor-engaged specialists.

The proposed amendments can be accessed [here](#) and a fact sheet that summarizes the main provisions of the proposed amendments can be accessed [here](#).

Comments regarding the proposed amendments to other PCAOB standards are due August 30, 2017 and may be submitted via the PCAOB's website, as indicated in the proposal document.

CONCLUSION AND NEXT STEPS

We encourage you to review the PCAOB publications cited above and engage your auditors in conversation about the PCAOB's new standard and its other proposals. BDO will be announcing and offering related learning opportunities to our clients and contacts. For further insights and resources, refer to [BDO's Center for Corporate Governance and Financial Reporting](#).

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