

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

BDO **FLASH** REPORT

CORPORATE GOVERNANCE



SUBJECT

PCAOB REPROPOSES STANDARD TO ENHANCE THE AUDITOR'S REPORT FOR CRITICAL AUDIT MATTERS

SUMMARY

On May 11, 2016, the PCAOB repropoed for public comment the standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments (the "reproposed standard"). The reproposed standard is accessible [here](#) and a summary in the form of a PCAOB Fact Sheet [here](#).

DETAILS

The reproposed standard revises the PCAOB's initial proposal issued in August 2013. Similar to the 2013 proposal, the reproposed standard would retain the existing "pass/fail" model in the auditor's report, but would provide additional information in the report, such as the communication of critical audit matters and new elements related to auditor independence and auditor tenure.

A "critical audit matter" (CAM), as defined in the reproposed standard, is any matter that is 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) involves especially challenging, subjective, or complex auditor judgment. The auditor's report would identify the CAM, describe the considerations that led the auditor to conclude that such matter is a CAM, describe how it was addressed in the audit, and refer to the relevant financial statement accounts and disclosures. The PCAOB's decision tree below includes a principles-based framework leveraging the work already performed by the auditor under existing PCAOB standards.

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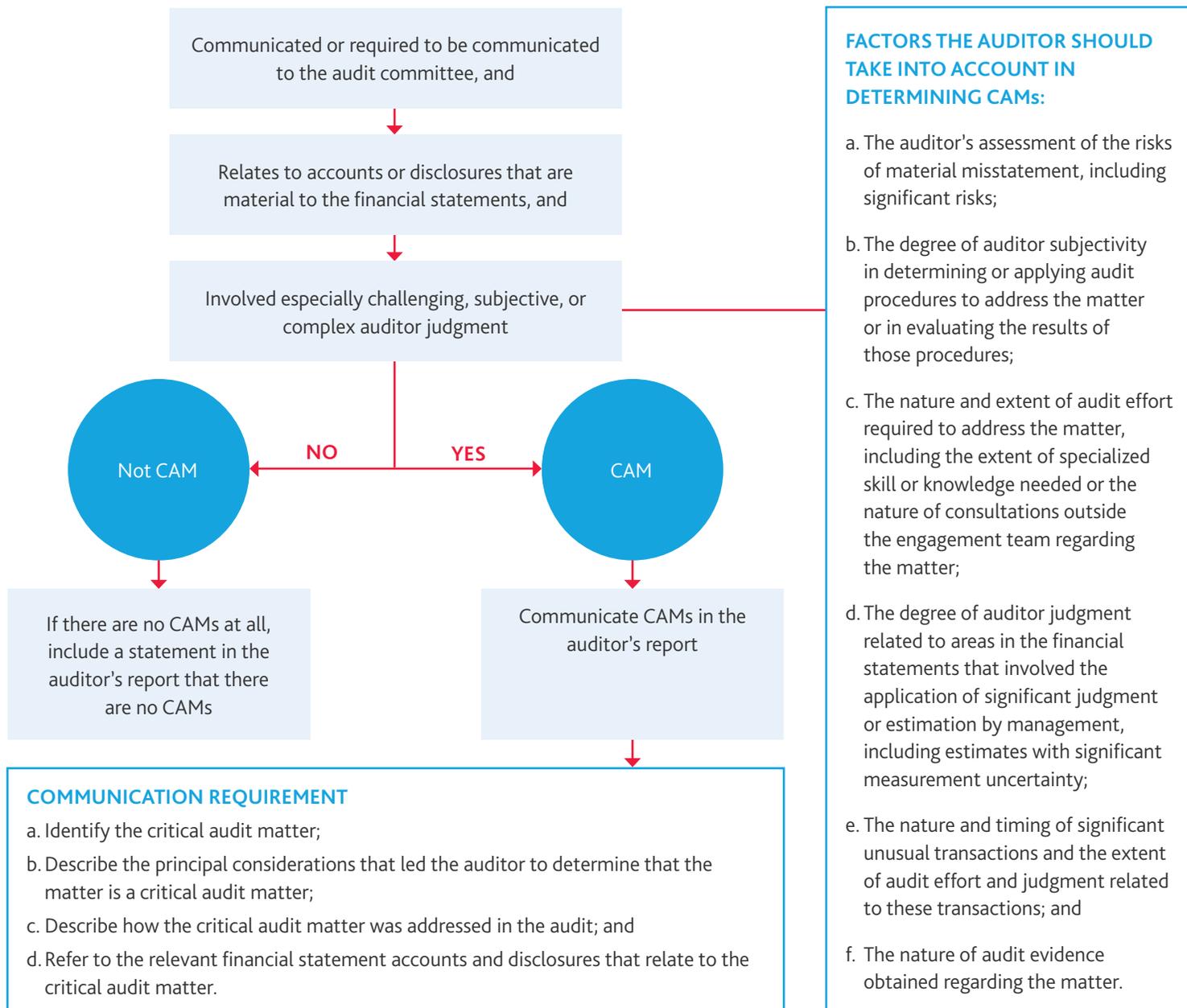
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By using such a framework, the PCAOB anticipates that CAMs would be scalable based on the size, nature, and complexity of the audit engagement :

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



Source: Adapted from PCAOB Release no. 2016-003

The repropoed standard has been refined in a number of respects from the 2013 proposal, including:

- ▶ Limiting the source of potential CAMs to matters communicated or required to be communicated to the audit committee¹
- ▶ Adding a materiality component to the definition of a CAM

¹ Refer to *BDO's Communications with Audit Committees – Overview of PCAOB Auditing Standard No. 16* for further information available [here](#) and *BDO's Flash Report* on the approval of PCAOB Standard No. 18, Related Parties, available [here](#). Shortly, BDO intends to release a comprehensive audit committee practice aid that lists required communications as determined by standard-setters and regulators along with several U.S. listing exchanges which will be made available on www.bdo.com.

- ▶ Narrowing the definition of a CAM to only those matters that involved especially challenging, subjective, or complex auditor judgment
- ▶ Revising the related documentation requirement to be consistent with the definition of a CAM
- ▶ Requiring the auditor to describe in the audit report how the CAM was addressed during the audit

OBSERVATIONS

Source of CAMs: The filter used to determine the population of possible CAMs recognizes the audit committee's oversight of the audit, such that the CAMs would 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: Auditors would be required to consider CAMs related to accounting or disclosures that are material to the financial statements. "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. For example, the auditor's evaluation of the company's goodwill impairment assessment could be a CAM; it would relate to goodwill because impairment is an element of that account. In addition, 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. For example, the auditor's evaluation of the company's ability to continue as a going concern or the risk of management's override of internal control could also represent CAMs depending on the circumstances of a particular audit. Furthermore, matters arising during the audit not deemed to be CAMs by auditor could nonetheless be included in the description of the principal considerations that the auditor used to determine CAMs.

CAM Definition: Matters involving "challenging, subjective, or complex auditor judgment" would likely include matters of most interest to investors:

- ▶ significant management estimates and judgments made in preparing financial statements and the auditor's assessment of them
- ▶ areas of high financial statement and audit risk
- ▶ unusual transactions, restatements, and other significant changes to the financial statements; and the
- ▶ quality, not just the acceptability, of the company's accounting practices and policies.

For example, the auditor may communicate CAMs related to significant management estimates and judgments, highlight areas of high financial statement and audit risk, and discuss significant unusual transactions. However, the auditor would not be required to report on its assessment of management's significant estimates and judgments or on the quality (as opposed to merely the acceptability), of the company's accounting practices and policies or of the financial statements as a whole.

While the repropoed standard requires the auditor to communicate CAMs arising for the current audit period, the auditor would not be precluded from including CAMs for prior periods.

Disclosure of How CAMs Were Addressed in the Audit: The reproposal does not prescribe an approach for the how an auditor is to describe within the auditor's report how the CAM was addressed during the audit. It suggests that the auditor may describe: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements. With respect to item (3), language used to communicate a CAM should not imply that the auditor is providing a separate opinion on it or on the accounts or disclosures to which it relates. It is also not appropriate for the auditor to use language that could call into question the auditor's opinion on the financial statements, taken as a whole. The reproposal contains illustrative communication examples for consideration.

The reproposed standard would also include the following changes to the existing auditor's report:

- ▶ The auditor's report would include a statement about the requirement for the auditor to be independent.
- ▶ The phrase "whether due to error or fraud," would be added to the auditor's report when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements.
- ▶ A statement would be included in the auditor's report regarding how many years the auditor has served as the company's auditor
- ▶ The opinion would be required to be the first section of the auditor's report
- ▶ Section titles would be required in the auditor's report, to help guide the reader

OBSERVATIONS

Auditor Tenure: The PCAOB is proposing that rather than including auditor tenure in the new Form AP², it would be disclosed in the auditor's report as the primary vehicle by which the auditor communicates with investors.

The 2013 proposal also included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements. The Board is not reproposing this auditing standard at this time but plans to determine next steps at a later date.

The reproposed standard would generally apply to audits conducted under PCAOB standards. Unlike the 2013 proposal, however, the requirements regarding CAMs would not apply to audits of brokers and dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5; investment companies other than business development companies; and employee stock purchase, savings, and similar plans.

The reproposal contains numerous questions for commenters to consider. Comments on the reproposal are due August 15, 2016.

We encourage you to explore the resources cited as you fulfill your duties on behalf of the boards and companies that you serve. For additional audit committee along with financial accounting and reporting tools and resources, visit BDO's Board Governance page at: www.bdo.com/services/assurance/board-governance/overview.

² The SEC recently approved the PCAOB's new rule requiring disclosure of the engagement partner and other audit firms participating in the audit within a new PCAOB Form AP, Auditor Reporting of Certain Audit Participants. Audit firms are required to file the name of the engagement partner for all public company audits issued on or after January 31, 2017. Information about other audit firms participating in the audit must be filed for all public company audits issued on or after June 30, 2017. Refer [here](#).

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