

The Auditor's Report – New Requirements for 2017

Introduction

The Center for Audit Quality (CAQ) is pleased to release CAQ Alert No. 2017-06, *The Auditor's Report – New Requirements for 2017* (the Alert) to highlight for auditors, preparers, and audit committee members upcoming changes in the auditor's report. A new auditing standard, [AS 3101](#), The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, was adopted by the Public Company Accounting Oversight Board (PCAOB) on June 1, 2017, and approved by the Securities and Exchange Commission (SEC) on October 23, 2017.

This new auditing standard requires significant changes to the auditor's report to be implemented in two phases. In the first phase, changes are intended to provide information about auditor tenure and clarify the auditor's responsibilities. In the second phase, the auditor is required to provide new information about the audit. The auditor's report will continue to be a pass/fail model.

First Phase of Implementation – Auditor Tenure and Other Changes

The first phase of implementation, which affects audit reports issued on financial statements of public companies for fiscal years ending on or after December 15, 2017, includes disclosing auditor tenure and other changes to the auditor's report.¹

AUDITOR TENURE

Under the first phase of implementation of the new PCAOB standard, the auditor's report will be required to include a statement containing the year the auditor began serving consecutively as the company's auditor.² According to the PCAOB, auditor tenure is determined by taking into account firm or company mergers, acquisitions, or changes in ownership structure. The determination of auditor tenure should reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit.³ For example, assuming no change in the auditor other than the acquisition, if Accounting Firm A started auditing Company XYZ in 2005, and was subsequently acquired by Accounting Firm B, then Accounting Firm B would indicate in its auditor's report for Company XYZ that it has served as the Company's auditor since 2005.

Additionally, if a company went public and maintained the same auditor, auditor tenure should include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.⁴ If there is uncertainty

¹ Related to the first phase of implementation, the requirements of [PCAOB Release No. 2017-001](#), *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* apply to brokers and dealers, Form 11-K filers, investment companies, and emerging growth companies. For all elements of the auditing standards, auditors may elect to comply at any point before the effective date.

² *Ibid.*, page A1-6 (paragraph 10.b).

³ *Ibid.*, page 48. The note to paragraph 10.b of the final auditing standard states, "references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm."

⁴ *Ibid.*

as to the year the auditor began serving consecutively as the company’s auditor, “the auditor should state that the auditor is uncertain as to the year the auditor became the company’s auditor and provide the earliest year of which the auditor has knowledge.”⁵ Auditors should begin to collect the information needed to determine auditor tenure, including, if appropriate, engaging with management and audit committees.

In the PCAOB’s view, auditor tenure is another data point about the auditor, in addition to the firm name and the office issuing the auditor’s report. As a result of the new requirement to disclose auditor tenure, audit committees may want to consider adding or expanding disclosure related to their external auditor selection and retention processes, including consideration of auditor tenure, in the proxy statement to provide context.⁶

While the illustrative auditor’s report provided in the new auditing standard includes the statement on auditor tenure at the end of the report, between the auditor’s signature and the date of the report, the new auditing standard does not specify a required location within the auditor’s report for the statement on auditor tenure.

OTHER CHANGES IN THE AUDITOR’S REPORT ON FINANCIAL STATEMENTS

Certain other changes required as part of the first phase of implementation, listed below, are not complex or judgmental in nature; however, they will likely take time for audit firms to implement – to update tools, templates, and training.⁷ Auditors should consider discussing these changes with preparers and audit committee members to help them understand what to expect. These changes are also required to be included in auditor’s reports for audits of fiscal years ending on or after December 15, 2017.

- ▶ Independence—a statement that the auditor is required to be independent;
- ▶ Addressee—the auditor’s report will be addressed to the company’s shareholders and board of directors or equivalents (additional addressees are also permitted);
- ▶ Enhancements to basic elements—certain standardized language in the auditor’s report has been changed, including adding the phrase “whether due to error or fraud,” when describing the auditor’s responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements; and
- ▶ Standardized form of the auditor’s report—the opinion will appear in the first section of the auditor’s report and section titles have been added to guide the reader.

Second Phase of Implementation – Communication of Critical Audit Matters

The second phase of implementation requires communication of critical audit matters (CAMs).⁸ A CAM is defined as a 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.⁹

⁵ Ibid, page A1-6 (paragraph 10.b).

⁶ The 2016 [Audit Committee Transparency Barometer](#), an annual report issued jointly by the Center for Audit Quality and Audit Analytics notes that audit committees are increasingly providing such disclosure and provides examples of such disclosures. The 2017 *Audit Committee Transparency Barometer* will be released on or around November 1, 2017.

⁷ There are also certain changes related to explanatory language added to the auditor’s report, emphasis of a matter and information about certain audit participants ([PCAOB Release No. 2017-001](#), page A1-11-14, paragraphs .18-.20).

⁸ The final auditing standard generally applies to audits conducted under PCAOB standards. However, communication of critical audit matters is not required for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 (Exchange Act) Rule 17a-5; investment companies other than business development companies; employee stock purchase, savings, and similar plans (benefit plans); and emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act. Auditors of these entities may choose to include critical audit matters in the auditor’s report voluntarily. The other requirements of the new auditing standard will apply to these audits.

⁹ Similar changes have taken effect in other jurisdictions. In September 2014, the International Auditing and Assurance Standards Board (IAASB) adopted International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*. See the IAASB’s [publications](#) comparing IAASB and PCAOB auditing standards related to the new auditor’s report.

When determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account certain factors (as specified in the new auditing standard), including the auditor’s assessment of the risks of material misstatement.

The communication of each CAM in the auditor’s report includes:

- ▶ the 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 in the audit; and,
- ▶ a reference to the relevant financial statement accounts or disclosures.

The PCAOB “expects that, in most audits to which the requirement to communicate CAMs applies, the auditor will determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.”¹⁰ However, if the auditor determines there are no CAMs to communicate, the auditor is required to make a statement to this effect in the auditor’s report.¹¹

The effective dates for CAMs to be included in the auditor’s report are as follows:

- ▶ For audits of large accelerated filers: fiscal years ending on or after June 30, 2019; and
- ▶ For audits of all other companies to which the requirements apply: fiscal years ending on or after December 15, 2020.

Communication of CAMs is considered the most significant change required by the new auditing standard. While CAMs are not required in the first phase of implementation (i.e., in the auditor’s report for fiscal years ending on or after December 15, 2017), we encourage auditors, audit committee members, and preparers to engage early in a discussion about CAMs. These discussions can assist preparers and audit committee members in understanding the intent of the new requirements. The CAQ plans to release additional information on communication of CAMs in the near future.

¹⁰ [PCAOB Release No. 2017-001](#), page 37.

¹¹ *Ibid.*