THE AUDITOR’S REPORT
CONSIDERATIONS FOR AUDIT COMMITTEES

CENTER FOR AUDIT QUALITY

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Introduction

This publication aims to assist audit committees in preparing to navigate the new auditor’s reporting model.

Changes to the auditor’s report are a result of the Public Company Accounting Oversight Board’s (PCAOB) June 2017 adoption of a new auditing standard, **AS 3101, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion** (the “new standard”). Approved by the Securities and Exchange Commission (SEC) on October 23, 2017, this new standard features a phased implementation approach.

The first phase of implementation—which affects PCAOB audits of companies with fiscal years ending on or after December 15, 2017—includes disclosing auditor tenure and other changes to the form and content of the auditor’s report.

The second phase of implementation requires communication of critical audit matters (CAMs). 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
► For audits of all other companies to which the requirements apply: fiscal years ending on or after December 15, 2020

As the new standard was recently approved by the SEC, audit firms are actively working to plan and execute against the first phase of requirements, and beginning to prepare and plan for the implementation of the second phase. In a recent speech discussing the new auditor’s report, Wesley R. Bricker, SEC Chief Accountant, remarked, “As part of getting started, I encourage auditors to update their methodologies, provide training, and at the engagement team level, use the transition period to engage in dialogue with audit committees so that audit committees have time to understand the types of matters that may be communicated as critical audit matters in the audit reports.” Bricker also went on to note that “audit committees should have reasonable expectations that auditors prepare to take members through the application of the standard on their engagement.”

The ongoing dialogue between auditors and audit committees during the phases of implementation will be a critical component of implementing this new standard. This publication provides suggested questions and information for audit committees to consider when developing their understanding of the impact of these changes to the auditor’s report.

These questions and considerations are not meant to be all-inclusive, nor are they intended to be used as a checklist. Rather, this publication is meant to spur dialogue and to assist audit committees in enhancing their understanding of the impact that the new auditor’s report will have on the audit process and interactions with auditors, management, and investors.

**FIRST PHASE OF IMPLEMENTATION**

**Auditor Tenure and Other Changes**

A number of changes to the auditor’s report in this phase are intended to (1) clarify the auditor’s role and responsibilities and (2) make the auditor’s report easier to read.

**AUDITOR TENURE**

Under the first phase of implementation of the new 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. According to AS 3101, auditor tenure is determined, in part, by taking into account firm or company mergers, acquisitions, or changes in ownership structure. In addition, the determination of auditor tenure should include the tenure of predecessor accounting firms and engagement by predecessors of the company under audit. Auditor tenure may be one data point that is balanced among the various factors considered by the audit committee in weighing their selection or retention of the external auditor and their oversight of the audit relationship. While the PCAOB has acknowledged that there is no conclusive linkage between tenure and audit quality, auditor tenure may be one data point.

As a result of the prominence of the new tenure disclosure and the limited amount of context and explanatory language included in the disclosure of auditor tenure in the auditor’s report, 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. The 2017 Audit Committee Transparency Barometer, an annual report issued jointly by the CAQ and Audit Analytics, notes that audit committees are increasingly providing such disclosure, and the publication provides disclosure examples.

OTHER CHANGES IN THE AUDITOR’S REPORT

Certain other changes are not complex or judgmental in nature. Audit committees should consider discussing with management and auditors to help understand how the form and content of their auditor’s report will change. Auditors are required by AS 1301 to provide to and discuss a draft of the auditor’s report with the audit committee; however, audit committees may consider discussing the timing of this communication with the auditor. The following changes are required to be included in auditor’s reports for audits of fiscal years ending on or after December 15, 2017.

- 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.
- Independence—The auditor’s report must include 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.

FIRST PHASE OF IMPLEMENTATION

Questions

AUDITOR TENURE

1. How is auditor tenure determined?
2. Are there complexities to the relationship with the auditor that may make determining auditor tenure less straightforward (e.g., company mergers, audit firm mergers)?
3. What if there is uncertainty as to the year the auditor began serving consecutively as the company’s auditor? If so, how will this be communicated in the auditor’s report?

6 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.”
8 “The Board is not persuaded by commenters’ concerns that disclosure of auditor tenure in the auditor’s report necessarily suggests a specific correlation between auditor tenure and audit quality, or between auditor tenure and auditor independence. In the Board’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, for which there is demonstrable investor demand.” (PCAOB Release No. 2017-001, page 47).
9 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, pages A1-11-14, paragraphs .18-.20).
10 Please note this change to the auditor’s report is not expected to change the required communications between the auditor and audit committee about auditor independence.
4. Has the audit firm determined a different tenure than what the company may already have or plans to disclose on a voluntary basis (e.g., in a proxy statement)? If so, what are the reasons for such differences?

5. Has management or the audit committee considered the sufficiency of proxy disclosures around audit committee oversight of auditors, including considerations related to auditor appointment and retention given the new tenure disclosure?

6. Has the company considered how they will respond to questions they may receive from investors about auditor tenure?

OTHER CHANGES IN THE AUDITOR’S REPORT

1. What are examples of some of the more significant changes to the auditor’s report effective in the first phase of implementation?

2. What changes to the format of the report will occur and when?

SECOND PHASE OF IMPLEMENTATION
Communication of Critical Audit Matters

Communication of CAMs is considered the most significant change required by the new standard. 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.11

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 standard),12 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,13 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.”14 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.15

While CAMs are not required in the first phase of implementation, the addition of CAMs as part of the second phase of implementation represents the most significant change to the auditor’s report. Audit committees may want to consider engaging in initial discussions in the near term with their auditor regarding the audit firm’s planned approach to implementing the CAM component of the new standard as well as what matters could theoretically be CAMs.

11 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.

12 See AS 3101.12a-f.

13 See AS 3101.14c.


15 Ibid.
SECOND PHASE OF IMPLEMENTATION

Questions

AUDIT FIRM’S APPROACH TO IMPLEMENTATION OF CAM REQUIREMENT

1. What is the audit firm’s plan for the second phase of implementation?
   a. What are the audit firm’s plans to develop their firm methodology and guidance for identifying and communicating CAMs?
   b. Does the audit firm plan to field test their methodology in advance of the effective date?
      i. If the audit firm plans to test their methodology:
         1. When do they expect to perform that testing?
         2. Will example audit reports, including CAMs, be part of the testing methodology?
         3. What is the audit committee’s and/or company management’s role during any planned testing?

2. How is the audit firm thinking about what matters might be considered a potential CAM?

3. What impact does the timing of the identification of a CAM have on the communication among the auditor, management, and the audit committee?

As audit firms are preparing for the implementation of phase two, management and the audit committee may also want to think about whether their own processes are sufficient to understand and review the nature of the CAMs that the auditor expects to be reported. These considerations should include how this information may result in questions from investors, regulators, and others, as well as an assessment of current disclosures and whether any potential enhancements or other changes are appropriate in light of incremental attention that could result in areas likely to relate to CAMs. The new standard does not change the fact that it remains the responsibility of management, with the oversight of the audit committee, to communicate relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework.

The National Association of Corporate Directors (NACD) spends time identifying, interpreting, and delivering insights on critical issues that shape board agendas. Implementation of the new auditor’s report is a topic of interest with board members. Based on feedback from its members, the NACD has compiled common questions audit committee chairs are asking their auditors, management, and themselves about the new auditor’s report, specifically CAMs.

1. Should we consider discussing with our auditor their plans to pilot the new standard?

2. What areas during the 2018 audit do we anticipate our auditor will find challenging, subjective, or complex—and how can we constructively discuss those concerns in a timely fashion?

3. Will increased focus on CAMs affect the scope of the audit plan and the amount of audit work that needs to be performed in 2018, in advance of the year of implementation?

4. How will the auditor’s insights in the newly expanded report affect our ongoing work as we prepare the audit committee report for the proxy and review Management’s Disclosure and Analysis (MD&A), risk, and other disclosures in the annual report on Form 10-K?

5. Which matters expected to be CAMs do we already disclose in our significant accounting policies and critical accounting estimates section of MD&A?

6. Do the auditors anticipate having to include their national or regional office leadership in the review or approval of CAMs? If so, how will their involvement affect the timing of the determination of this at year end?
What’s Next?

This document is intended to foster a dialogue among audit committees, auditors, and others about the implementation of expanded auditor reporting. These questions are merely a starting point for preparing for the new auditor’s reporting model. In a recent speech, Chief Accountant Bricker also noted that, "timely, ongoing communication will continue to be an important element to the auditor-audit committee relationship as the auditors implement this auditor reporting standard.” More detailed discussions on the tools, templates, and guidance that audit firms plan to develop for phase two of the implementation will happen as firms make progress on executing their implementation strategies and processes, and the CAQ plans to release more publications to promote such a dialogue.


About the Center for Audit Quality

The CAQ is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors’ objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.