Critical Audit Matters: What Lawyers Need to Know About the PCAOB’s New Auditor Reporting Standard

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Program Resource Materials


2. AS 3101.11-.17 (Critical Audit Matters).


THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting a new standard, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, that will replace portions of AS 3101, Reports on Audited Financial Statements. The remaining portions of AS 3101 will be redesignated as AS 3105, Departures from Unqualified Opinions and Other Reporting Circumstances. The Board is also adopting related amendments to PCAOB standards.

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Contents

I. Summary .......................................................................................................................... 1

II. Background ................................................................................................................... 4
   A. Rulemaking History ...................................................................................................... 4
   B. Initiatives of Other Regulators and Standard Setters .................................................. 7

III. Overview of the Final Standard .................................................................................. 11

IV. Discussion of the Final Standard .................................................................................. 15
   A. Critical Audit Matters .................................................................................................. 15
   B. Additional Improvements to the Auditor's Report ....................................................... 44
   C. Explanatory Language and Emphasis of a Matter ......................................................... 55
   D. Information about Certain Audit Participants ............................................................. 58
   E. Form of the Auditor's Report ...................................................................................... 59
   F. Application to Other Audits Performed Under PCAOB Standards ............................... 60

V. Amendments to Other PCAOB Standards .................................................................... 61
   A. AS 3105, Departures from Unqualified Opinions and Other Reporting
      Circumstances ............................................................................................................. 61
   B. Other Amendments to PCAOB Standards .................................................................. 63

VI. Economic Considerations ............................................................................................. 64
   A. Need for the Rulemaking ............................................................................................. 65
   B. Baseline ...................................................................................................................... 72
   C. Benefits ...................................................................................................................... 75
   D. Costs and Potential Unintended Consequences .......................................................... 86
   E. Alternatives Considered, Including Policy Choices under the Final Standard ......... 96

VII. Applicability of Critical Audit Matter Requirements ................................................ 101
   A. Brokers and Dealers, Investment Companies, and Benefit Plans ............................... 101
   B. Smaller Companies .................................................................................................... 108

VIII. Considerations for Audits of Emerging Growth Companies .................................... 109
   A. Critical Audit Matters ................................................................................................. 110
   B. Additional Improvements to the Auditor's Report ...................................................... 112

IX. Effective Date ............................................................................................................... 113

Appendix 1: AS 3101, The Auditor's Report on an Audit of Financial Statements When
   the Auditor Expresses an Unqualified Opinion .............................................................. A1-1

Appendix 2: Amendments to Other PCAOB Standards .................................................. A2-1
I. Summary

The Board is adopting a new auditor reporting standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "final standard" or "AS 3101") and related amendments to its auditing standards that will require the auditor to provide new information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- Communication of critical audit matters—matters 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) involved especially challenging, subjective, or complex auditor judgment;

- Disclosure of auditor tenure—the year in which the auditor began serving consecutively as the company's auditor; and

- Other improvements to the auditor's report—a number of other improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

The Board believes that adopting these requirements responds to the strong interest of investors for enhanced communication about the audit and is consistent with its mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."¹

The Board is adopting the final standard after more than six years of outreach and public comment, including comments from members of the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG"). The Board has taken into consideration all comments and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate.

Investors are the beneficiaries of the audit and the auditor's report is the primary means by which the auditor communicates with them. Currently, however, the auditor's report conveys little of the information obtained and evaluated by the auditor as part of

the audit. And while the auditor's report has generally remained unchanged since the 1940s, companies' operations have become more complex and global, and the financial reporting frameworks have evolved toward an increasing use of estimates, including fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, but the auditor's report does not communicate this information to investors. Stated differently, the auditor's report does little to address the information asymmetry between investors and auditors, even though investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for their benefit. The Board believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management. Outside the United States, other regulators and standard setters have already adopted expanded auditor reporting.

The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed these matters. The Board believes that these matters will likely be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements. The final standard is designed to elicit more information about the audit directly from the auditor. The Board believes that the critical audit matter requirements will respond to requests from investors for more information from the auditor while appropriately addressing concerns raised by other commenters.

Economists often describe this imbalance, where one party has more or better information than another party, as "information asymmetry." As part of the system of financial reporting, the audit of the financial statements helps reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

Investors and investor advocates have suggested a variety of ways in which investors can use the information provided in critical audit matters. In the view of some investors, critical audit matters will add to the total mix of information, providing insights relevant in analyzing and pricing risks in capital valuation and allocation, and contributing to their ability to make investment decisions. Investors also stated that critical audit matters will focus their attention on key financial reporting areas and identify areas that deserve more attention, enhancing the efficiency of investors and others in the consumption of financial information. Some investors believe that critical audit matters will highlight areas that they may wish to emphasize in their engagement with the company and provide important information that they can use in making proxy voting decisions, including ratification of the appointment of auditors.

The final standard also includes a new required statement in the auditor's report disclosing the year in which the auditor began serving consecutively as the company's auditor, as well as a number of other improvements to the auditor's report, such as a statement regarding the requirement for the auditor to be independent. Requiring disclosure of auditor tenure in the auditor's report will make this information readily accessible in a timely way for investors who find it useful. The other improvements to the auditor's report are intended to enhance the user's understanding of the auditor's role and responsibilities related to the audit of the financial statements, make the auditor's report easier to read, and provide a consistent format.

The final standard will generally apply 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 (the "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 ("EGCs"), 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 final standard will apply to these audits.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and complexity of the audit.

The Board is adopting a phased approach to the effective dates for the new requirements to provide accounting firms, companies, and audit committees more time to prepare for implementation of the critical audit matter requirements, which are expected to require more effort to implement than the additional improvements to the auditor's report. Subject to approval by the Securities and Exchange Commission ("SEC"), the final standard and amendments will take effect as follows:
All provisions other than those related to critical audit matters will take effect for audits of fiscal years ending on or after December 15, 2017; and

Provisions related to critical audit matters will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

Auditors may elect to comply before the effective date, at any point after SEC approval of the final standard.

II.  Background

A.  Rulemaking History

Changes to the auditor's report have been discussed by several commissions and committees, including the 2008 U.S. Department of the Treasury Advisory Committee on the Auditing Profession (“ACAP”). ACAP recommended that the PCAOB consider improvements to the auditor's report, noting that the increasing complexity of global business operations compels a growing use of judgments and estimates, including those related to fair value measurements, and contributes to greater complexity in financial reporting. ACAP said this complexity supported improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.

The PCAOB commenced its standard-setting project on the auditor's reporting model in 2010 with outreach to different stakeholders, including investors, financial statement preparers, and auditors. During that outreach, many investors expressed dissatisfaction with the content of the existing auditor's report because it provides investors little, if any, information specific to the audit of the company's financial statements. Generally, preparers, audit committee members, and auditors were not supportive of adding company-specific information to the auditor's report, arguing that the company, through its management or audit committee, should be the primary source of the company's financial information. Changes to the auditor's report were also

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discussed at the March 2011 IAG meeting. Some investors who participated in that meeting suggested that expanded auditor reporting would have been helpful before and during the 2008 financial crisis. Later in March 2011, the Board held an open meeting to discuss findings from its outreach.

In June 2011, the Board issued a concept release to solicit comment on a number of potential changes to the auditor's report. The Board received 155 comment letters on the concept release. The Board also held a public roundtable in September 2011 to obtain additional insight on the alternatives presented in the concept release. Changes to the auditor's report were also discussed at the November 2011 and 2012 meetings of the Board's SAG.

After considering the results of its outreach and comments on its concept release, in August 2013, the Board proposed an auditing standard that included new requirements for auditors to communicate critical audit matters, as well as additional improvements to the auditor's report. The Board received 248 comment letters on the

5 See IAG meeting details and webcast (Mar. 2011), available on the Board's website.

6 See IAG working group presentation, Lessons Learned from the Financial Crisis (Mar. 16, 2011), available on the Board's website.

7 See PCAOB open Board meeting details and webcast (Mar. 22, 2011), available on the Board's website.


9 See PCAOB roundtable transcript (Sept. 15, 2011), available on the Board's website in Docket 034.

10 See SAG meeting transcripts (Nov. 2011 and 2012), available on the Board's website in Docket 034.

proposal. Most commenters generally supported the Board's objective to improve the auditor's report to make it more informative and relevant to financial statement users, but commenters' views varied on the nature and extent of such changes, particularly as to critical audit matters.\textsuperscript{12} Investors, analysts, and larger accounting firms generally supported communication of critical audit matters with some modifications, while many smaller accounting firms were less supportive, and preparers and audit committee members generally opposed communication of critical audit matters. Commenters generally supported the additional improvements to the auditor's report other than the disclosure of auditor tenure in the auditor's report, which investors supported and some other commenters opposed or suggested should be provided in a different document, such as the proxy statement.

In April 2014, the Board held a public meeting to obtain further input on the proposal from a diverse group of investors and other financial statement users, preparers, audit committee members, auditors, and others.\textsuperscript{13} The proposal was further discussed at the November 2013 and June 2014 SAG meetings, and the October 2013 and 2014 IAG meetings.\textsuperscript{14}

In May 2016, the Board issued a reproposal of the auditor reporting standard that modified the proposal in several respects.\textsuperscript{15} In particular, the reproposal modified the source, definition, and communication requirements for critical audit matters. The Board received 88 comment letters on the reproposal. The reproposal was discussed at the May 2016 SAG meeting and October 2016 IAG meeting.\textsuperscript{16}

\begin{footnotes}
\footnotetext[12]{See comment letters on the proposal, available on the Board's website in Docket 034.}
\footnotetext[13]{See public meeting transcripts and participant statements (Apr. 2-3, 2014), available on the Board's website in Docket 034.}
\footnotetext[14]{See SAG (Nov. 2013 and June 2014) and IAG meeting transcripts (Oct. 2013 and 2014), available on the Board's website in Docket 034.}
\footnotetext[16]{See SAG (May 18, 2016) and IAG (Oct. 27, 2016) meeting transcripts, available on the Board's website in Docket 034.}
\end{footnotes}
Several commenters on the reproposal suggested that the Board engage in further outreach, field testing, or further study before finalizing the standard. One commenter suggested deferral until the SEC completes any rulemaking on its "disclosure effectiveness" initiative. However, other commenters commended the Board on the extensive outreach already performed. The Board believes that its extensive outreach provides an adequate basis to adopt the final standard.

B. Initiatives of Other Regulators and Standard Setters

1. Overview of the Requirements of the IAASB, the EU, and the FRC

The form and content of the auditor's report have undergone change globally. In recent years, several international regulators and standard setters, including the International Auditing and Assurance Standards Board ("IAASB"), the European Union ("EU"), and the Financial Reporting Council in the United Kingdom ("FRC"), have adopted requirements for expanded auditor reporting that go beyond the binary pass/fail model. While their underlying requirements for expanded auditor reporting differ in the details, there is a common theme in these initiatives: communicating information about audit-specific matters in the auditor's report. In addition to expanded auditor reporting, many of these initiatives also include other changes to the form and content of the auditor’s report.

Several commenters have urged the Board to align the final standard with the requirements of other regulators and standard setters. The Board recognizes that the regulatory environments in other jurisdictions are different from the environment in the United States; the Board must address unique U.S. requirements and characteristics in its standard-setting projects. Even so, the Board has considered carefully the efforts undertaken in other jurisdictions, and, as described in more detail below, the final requirements are analogous in many respects to auditor reporting requirements established in other jurisdictions.

IAASB. In September 2014, the IAASB adopted changes to the requirements for the auditor's report, including a new requirement for the auditor to communicate "key audit matters" for audits of listed companies. Key audit matters are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected

17 The IAASB changes to the auditor’s report are effective for audits of financial statements for periods ending on or after December 15, 2016.

18 See paragraph 8 of International Standard on Auditing ("ISA") 701, Communicating Key Audit Matters in the Independent Auditor's Report.
from matters communicated with those charged with governance and that required significant auditor attention in performing the audit.\textsuperscript{19} The IAASB requires that the description of each key audit matter in the auditor's report include: (1) why the matter was considered to be a key audit matter, (2) how the matter was addressed in the audit, and (3) reference to the related disclosures, if any, in the financial statements.\textsuperscript{20}

As part of its auditor reporting project, the IAASB also adopted additional changes to the form and content of the auditor's report. These include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit,\textsuperscript{21} an enhanced description of the responsibilities of the auditor,\textsuperscript{22} and requiring the auditor's opinion to be the first paragraph of the auditor's report.\textsuperscript{23}

\textit{EU.} In April 2014, the EU adopted legislation creating a number of new requirements, including expanded auditor reporting requirements, for audits of public-interest entities ("PIEs"), such as listed companies, credit institutions, and insurance companies.\textsuperscript{24} Under the EU reforms, the auditor's report for a PIE is required to include a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, as well as a summary of the auditor's response to those risks and, where relevant, key observations arising with respect to those risks. In addition, the EU reforms require a statement that the auditor remained independent of the audited entity and disclosure of auditor tenure.

\textsuperscript{19} See paragraph 9 of ISA 701.

\textsuperscript{20} See paragraph 13 of ISA 701.

\textsuperscript{21} See paragraph 28(c) of ISA 700 (Revised), \textit{Forming an Opinion and Reporting on Financial Statements}.

\textsuperscript{22} See paragraph 37 of ISA 700.

\textsuperscript{23} See paragraph 23 of ISA 700.

\textsuperscript{24} See Article 10, \textit{Audit Report}, of Regulation (EU) No 537/2014 of the European Parliament and of the Council ("Regulation (EU) No 537/2014") (Apr. 16, 2014). EU member states had until June 2016 to adopt the provisions of the EU legislation into their own national laws and rules. Information on member state implementation is available in the "Audit reform in the EU" section of the European Union's webpage.
FRC. In June 2013, the FRC revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code.\(^\text{25}\) The auditors of those entities were required, among other things, to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of resources in the audit; and (3) directing the efforts of the engagement team. In addition, auditors were required to provide an explanation of how the scope of the audit addressed the risks.\(^\text{26}\)

In April 2016, the FRC adopted a final rule, which applies to all listed entities, updating its 2013 auditor reporting requirements to incorporate the EU\(^\text{27}\) and the IAASB requirements.\(^\text{28}\) Under the final rule, the FRC adopted the IAASB's definition of key audit matters. In the application and other explanatory material on the definition of key audit matters, the FRC identified risks of material misstatement, as determined under both its existing requirements and those of the EU, as key audit matters under that definition. When the FRC proposed these rule changes in September 2015, it stated that it did not expect the incorporation of its own requirements and those of the EU to result in an increase in the number of key audit matters communicated in the auditor's report over what would be required by the IAASB standard alone.\(^\text{29}\)

\(^{25}\) These entities include companies with a premium listing of equity shares on the London Stock Exchange, regardless of whether they are incorporated in the U.K. or elsewhere. The changes made to the auditor's report were designed to complement other changes made to the UK Corporate Governance Code that require the audit committee to describe significant issues it considered relating to the financial statements. See Section C.3.8 of FRC UK Corporate Governance Code (Sept. 2012).


\(^{27}\) In response to questions about the implications of the June 2016 UK referendum decision to leave the EU, the FRC has stated: "Our regulatory framework is unchanged and we will continue to apply it." See FRC *statement following the referendum vote to leave the EU* (June 24, 2016).

\(^{28}\) See the FRC’s Final Draft, ISA (UK and Ireland) 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (Apr. 2016). This rule is effective for audits of financial statements for periods beginning on or after June 17, 2016.

\(^{29}\) See FRC, *Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance*
2. **Comparison of the Board's Final Standard to Other Requirements**

Even though the underlying auditor reporting requirements of other regulators and standard setters are different in the details, in many respects, the initiatives are analogous to the Board's final standard. All of these initiatives result in expanding the auditor’s report beyond the traditional pass/fail model to communicate information specific to the particular audit. Although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches.

Sections IV and V include descriptions of the IAASB, EU, and FRC requirements that are analogous to the key provisions of the final standard. In April 2016, the FRC adopted a final rule that updated its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, but auditor reporting under that final rule has not occurred yet. Because the FRC 2013 requirements govern the expanded auditor reporting that has occurred in the United Kingdom to date and are the subject of the FRC reports and academic studies described elsewhere in this release, the FRC 2013 requirements are used as a basis for comparison.

The IAASB’s standard is most similar to the Board's final standard. It requires the auditor to communicate "key audit matters" selected from matters communicated with those charged with governance. In May 2016, the IAASB published a comparison between its standard and the Board’s reproposal, which noted many similarities between the requirements of key audit matters and critical audit matters, including the framework for determination of the matters to be communicated, the considerations underlying the determination requirement, and communication requirements. \(^\text{30}\) Many commenters on the reproposal were supportive of the Board's closer alignment with the IAASB.

The FRC, under its 2013 requirements, and the EU start with the risks of material misstatement and contemplate a different process for determining matters to be communicated than the Board's final standard. The FRC has stated that key audit matters under the IAASB standard are broadly equivalent to the assessed risks of material misstatement included in the UK ISA 700 (2013). \(^\text{31}\) Under the Board's final

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standard, the auditor's assessment of the risks of material misstatement is one of the factors for the auditor to consider in determining critical audit matters.

The IAASB and the FRC 2013 requirements are accompanied by application and other explanatory materials that provide further guidance on the standards. Because these materials are not part of the requirements, they are not addressed in the descriptions of the requirements of other regulators and standard setters presented in Sections IV and V.

III. **Overview of the Final Standard**

The Board is adopting a new auditor reporting standard, which is attached as Appendix 1. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- **Critical audit matters** (see chart on page 14)—requires the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit of the financial statements or state that the auditor determined that there are no critical audit matters:
  
  - A critical audit matter is defined as a matter 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.
  
  - In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account, alone or in combination, certain factors, including, but not limited to:
    
    - The auditor's assessment of the risks of material misstatement, including significant risks;
    
    - The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and

The nature of audit evidence obtained regarding the matter.

The communication of each critical audit matter includes:

- Identifying the critical audit matter;
- Describing the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- Describing how the critical audit matter was addressed in the audit; and
- Referring to the relevant financial statement accounts or disclosures.

The documentation of critical audit matters requires that for each matter arising from the audit of the financial statements that (a) was communicated or required to be communicated to the audit committee, and (b) relates to accounts or disclosures that are material to the financial statements, the auditor documents whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.

Additional Improvements to the Auditor's Report—the final standard also includes a number of other improvements to the auditor's report that are primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements, provide additional information about the auditor, and make the auditor's report easier to read:

- Auditor tenure—a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;
- **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.

The Board intends to monitor the results of implementation, including consideration of any unintended consequences.
Determining and Communicating Critical Audit Matters ("CAMs")

**FACTORS THE AUDITOR SHOULD TAKE INTO ACCOUNT IN DETERMINING CAMs:**

a. The auditor's assessment of the risks of material misstatement, including significant risks;
b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and
f. The nature of audit evidence obtained regarding the matter.

**COMMUNICATION REQUIREMENTS**

a. Identify the critical audit matter;
b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
c. Describe how the critical audit matter was addressed in the audit; and
d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.
AS 3101: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion


Effective Date of Standard: For audits of fiscal years ending on or after Dec. 15, 2017, except for the requirements related to critical audit matters. The requirements related to critical audit matters in paragraphs .11–.17 will be effective for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020, for all other companies to which the requirements apply, as described in paragraph .05.

Amendments: Amending releases and related SEC approval orders

Guidance on AS 3101: [Staff Questions and Answers on Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor](#), [Staff Guidance for Auditors of SEC-Registered Brokers and Dealers](#), [Staff Guidance – Form AP, Auditor Reporting of Certain Audit Participants and Related Voluntary Audit Report Disclosure Under AS 3101, Reports on Audited Financial Statements](#) and [Staff Guidance – Changes to the Auditor’s Report Effective for Audits of Fiscal Years Ending on or After December 15, 2017](#)
Critical Audit Matters

Determination of Critical Audit Matters

.11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any 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. Critical audit matters are not a substitute for the auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105).

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and

f. The nature of audit evidence obtained regarding the matter.

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

Communication of Critical Audit Matters
The auditor must communicate in the auditor's report critical audit matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period's financial statements are presented on a comparative basis with those of one or more prior periods, the auditor may communicate critical audit matters relating to a prior period. This may be appropriate, for example, when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

For each critical audit matter communicated in the auditor's report the auditor must:

a. Identify the critical audit matter;

b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;

c. Describe how the critical audit matter was addressed in the audit; and

d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.

Note: In describing how the critical audit matter was addressed in the audit, the auditor may describe: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of the audit procedures performed; (3) an indication of the outcome of the audit procedures; and (4) key observations with respect to the matter, or some combination of these elements.

Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

Note 2: When describing critical audit matters in the auditor's report, 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 critical audit matter or how the matter was addressed in the audit.

*Language Preceding Critical Audit Matters in the Auditor's Report*

.15 The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

**Critical Audit Matters**

The critical audit matters communicated below are matters arising from the current period audit of the financial statements 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) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

.16 In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

**Critical Audit Matters**

Critical audit matters are matters arising from the current period audit of the financial statements 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) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.

*Documentation of Critical Audit Matters*
For each matter arising from the audit of the financial statements that:

a. Was communicated or required to be communicated to the audit committee; and

b. Relates to accounts or disclosures that are material to the financial statements;

the auditor must document whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.
21 Critical audit matters are not a substitute for required explanatory language (paragraphs) described in paragraph .18. If a matter that meets the definition of a critical audit matter also requires an explanatory paragraph, such as a matter related to going concern, the auditor may include the information required under paragraph .14 in the explanatory paragraph with a cross-reference in the critical audit matters section of the auditor's report to the explanatory paragraph. Alternatively, the auditor may include the explanatory paragraph and critical audit matter communication separately in the auditor's report and add a cross-reference between the two sections.

22 Consistent with the requirements of AS 1215, Audit Documentation, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the determinations made to comply with the provisions of this standard.
Statement on SEC Approval of the PCAOB’s New Auditor’s Reporting Standard

Oct. 23, 2017

The Public Company Accounting Oversight Board (“PCAOB” or “Board”) plays an important role in our capital markets as an independent audit regulator. The PCAOB’s work furthers the public interest, including the protection of investors, through its oversight of the preparation of independent audit reports. Today, the Commission approved a PCAOB rule that requires significant enhancements to certain public company audit reports, including the communication of critical audit matters (“CAMs”) and the disclosure of auditor tenure. These changes are intended to make the auditor’s report more informative.

The PCAOB commenced this project in 2010 in response to investor comments that the independent auditor’s report should provide more specific information about how the auditor reached his or her opinion.[1] The PCAOB engaged in three rounds of public solicitation of comment as well as substantial outreach to various stakeholder groups. The result of this deliberative process is the rule that the SEC approved today.

I strongly support the objective of the rule to provide investors with meaningful insights into the audit from the auditor. CAMs are designed to provide investors and other financial statement users with the auditor’s perspective on matters discussed with the audit committee that relate to material accounts or disclosures and involved especially challenging, subjective, or complex auditor judgment. Investors will benefit from understanding more about how auditors view these matters.

As discussed in the Commission’s approval order,[2] some commenters raised questions about the PCAOB’s rule. These questions included whether CAMs will result in an increase in litigation that does not benefit investors; whether CAMs will convey meaningful information specific to the audit or will instead provide boilerplate; and whether CAMs will chill auditor-audit committee dialogue. I am sensitive to these concerns.

In particular, I believe that the independent audit committee has emerged as one of the most significant and efficient drivers of value to Main Street investors. The audit committee’s key role in the oversight of the audit and the auditor, and in the integrity of a company’s accounting and financial reporting processes, has significantly enhanced financial reporting quality.[3] Impairing or otherwise negatively affecting the work of well-functioning audit committees could have significant adverse effects on investors.

I would be disappointed if the new audit reporting standard, which has the potential to provide investors with meaningful incremental information, instead resulted in frivolous litigation costs, defensive, lawyer-driven auditor communications, or antagonistic auditor-audit committee relationships — with Main Street investors ending up in a worse position than they were before.
I therefore urge all involved in the implementation of the revised auditing standards, including the Commission and the PCAOB, to pay close attention to these issues going forward, including carefully reading the guidance provided in the approval order and the PCAOB’s adopting release.

In this vein, I am also pleased the PCAOB intends to monitor the results of implementation, including consideration of any unintended consequences. Post-implementation review of new standards, including the use of economic analysis tools, is an important component of high-quality regulatory decision-making. The phased effective dates for CAMs should facilitate some early-stage analysis through the PCAOB’s Post-Implementation Review (PIR) process,[4] based on the experiences of large accelerated filers. Depending on the findings of this analysis, including an evaluation of unintended consequences, the Board should be open to making changes, if necessary, to the revised auditing standards, including to the effective date for companies other than large accelerated filers. Ultimately, I support a timely and effective PIR for these revised auditing standards, and it will be critical that this PIR is completed as soon as practicable. To this end, I have directed the SEC staff to assist as needed in that process.


[3] For example, we have observed a downward trend in the numbers of restatements. See e.g., Don Whalen et al., 2016 Financial Restatements: A Sixteen Year Comparison (Audit Analytics, May 2017) (“The quantity of reissuance restatements that are required to be disclosed in an 8-K, Item 4.02] has experienced nine consecutive years of decline to a low of 130 during 2016.”).


Related Materials

- PCAOB Order
Introduction

In 2017 the Public Company Accounting Oversight Board (PCAOB) adopted—and the Securities and Exchange Commission (SEC) approved—a new auditing standard: AS 3101, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (referred to hereafter as “the new standard”). The new standard significantly changes the auditor’s report. The first phase of implementation of the new standard which affects form and content of PCAOB audit reports for companies with fiscal years ending on or after December 15, 2017, is now effective.

This publication focuses on the second phase of implementation and a new fundamental required element of the auditor’s report: the auditor’s responsibility to determine and communicate critical audit matters (CAMs). We aim to assist audit committees, investors, and other users of financial statements in understanding this new required element. The effective dates for including CAMs 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 CAM requirements apply: fiscal years ending on or after December 15, 2020

Understanding Critical Audit Matters

The identification and communication of CAMs is the most significant change required by the new standard. This requirement is intended by the PCAOB to make the auditor’s report more informative and relevant to investors and other users of financial statements.

At the 2017 AICPA Conference on Current SEC and PCAOB Developments, SEC Chairman Jay Clayton noted that CAMs could result in enhanced reporting, provided CAM reporting does not result in boilerplate language that lacks meaningful information specific to the audit.

To realize the potential benefits of CAM reporting, ongoing dialogue among auditors, management, audit committees, and others will be critical both before, during, and after this second phase of implementation of the new standard.

WHAT IS A CAM?

According to the new standard, a CAM is:

- Any 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.

In its release, the PCAOB indicated that matters communicated or required to be communicated to the audit committee would be the appropriate source for critical audit matters, as those matters are the most meaningful to
In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

- The auditor’s assessment of the risks of material misstatement, including significant risks;
- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and
- The nature of audit evidence obtained regarding the matter.\(^7\)

users of the financial statements.\(^8\) The phrase “arising from the audit” aligns with the terminology used in the auditing standard for communications with the audit committee,\(^9\) which states that one of the objectives of the auditor is to provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.\(^10\)

The “relates to” aspect of the definition means that a matter must relate to an account or disclosure that is material to the financial statements to be a CAM. However, the matter does not necessarily need to correspond to an entire account or disclosure and therefore can be a component of an account or disclosure that is material to the financial statements.\(^11\)

For example, if goodwill was material to the financial statements, the auditor’s evaluation of the company’s goodwill impairment assessment could be a CAM, even if there was no impairment. The CAM 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.\(^12\)

Similarly, a matter may not relate to a single account or disclosure but still could be deemed a CAM because of its pervasive effect on the financial statements. For instance, the auditor’s evaluation of the company’s ability to continue as a going concern could be a CAM, depending on other facts and circumstances of that specific audit.\(^13\)

Alternatively, 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.\(^14\)

**HOW WILL AUDITORS DETERMINE WHETHER A MATTER IS A CAM?**

The determination of whether a matter is a CAM is principles based, and the new standard does not specify that any matter(s) would always be a CAM. When determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account certain nonexclusive factors (as specified in the new standard),\(^15\) such as the

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7 See AS 3101.12.
8 See page 16 of PCAOB Release 2017-001.
9 See page 17 of PCAOB Release 2016-003.
10 See AS 1301.03d.
11 See page 20 of PCAOB Release 2017-001.
12 Ibid.
13 Ibid.
14 See pages 20 and 21 of PCAOB Release 2017-001.
15 See AS 3101.12a–f.
auditor’s assessment of the risks of material misstatement, including significant risks.

For example, the new standard does not provide that a matter determined to be a significant risk would always constitute a CAM. Some significant risks may be CAMs, but not every significant risk will involve especially challenging, subjective, or complex auditor judgment.16

Similarly, the new standard does not require that matters such as material related party transactions or those involving the application of significant judgment or estimation by management always be a CAM.17

CAM Reporting in the Auditor’s Report

INTRODUCTORY LANGUAGE

The new standard requires introductory language to be included in the CAM section of the auditor’s report.18 This introductory language is intended to explain that CAMs do not alter the opinion on the financial statements taken as a whole and that the auditor is not providing a separate opinion on the CAMs.19

The new standard requires the following introductory language to be included in the CAMs section of the auditor’s report, preceding the CAMs communicated:

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements 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) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.20

CAM COMMUNICATION

Under the new standard, for each CAM communicated in the auditor’s report the auditor 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 disclosures that relate to the CAM.21

Consistent with the objective of providing more information about the audit, the new standard requires the auditor to describe how the CAM was addressed in the audit.22 While the new standard does not prescribe a specific approach for complying with this communication requirement, its objective is to provide a useful summary, as opposed to describing every aspect of how the matter was addressed in the audit or implying a separate opinion on the matter.23 The description should help financial statement users better understand these matters in relation to the audit of the financial statements.

16 See page 22 of PCAOB Release 2017-001.
17 Ibid.
18 See AS 3101.15.
19 See page 28 of PCAOB Release 2017-001.
20 See AS 3101.15.
21 See AS 3101.14a-d.
22 See AS 3101.14c
In describing how the CAM was addressed in the audit, the auditor may describe:

► the auditor’s response or approach that was most relevant to the matter;

► a brief overview of the audit procedures performed;

► an indication of the outcome of the audit procedures; and

► key observations with respect to the matter, or some combination of these elements.24

### Expanded Auditor Reporting Outside the United States

**REPORTING OF KEY AUDIT MATTERS (KAMs) OUTSIDE OF THE UNITED STATES**

The form and content of the auditor’s report have also undergone changes outside of the United States. The International Auditing and Assurance Standards Board (IAASB), the European Union, and the Financial Reporting Council have all adopted requirements that expanded auditor’s reports.

**EARLY EXPERIENCES WITH KAMs IN OTHER JURISDICTIONS**

The IAASB’s changes to the auditor’s reporting standards became applicable starting with December 2016 year-end audits in many jurisdictions. The Association of Chartered Certified Accountants (ACCA) published a report on the first year of implementation of the IAASB’s expanded auditor reporting standards.25 The ACCA’s report was the result of analysis performed on 560 auditor’s reports across 11 different countries as well as roundtables with auditors, preparers, audit committee members, investors, and regulators. The ACCA report states the research revealed the following additional benefits of KAMs to the financial reporting process:26

► KAMs encourage better conversations between the auditor and those charged with governance which in turn contributes to better governance;

► KAMs help the auditor to focus on the areas of the audit requiring the most careful judgement which in turn contributes to higher audit quality; and

► KAMs give preparers incentives for revisiting financial reporting and disclosures in areas related to those KAMs which in turn leads to better financial reporting, and in turn contributes to higher quality financial reporting.27

**COMPARING CAMs/ KAMs**

Both the PCAOB and IAASB auditor reporting standards were adopted with the overall intent of providing users of auditor’s reports with more audit-specific information. In the Appendix we have compared the underlying requirements of the PCAOB/IAASB standards for CAMs/KAMs. The PCAOB has stated, although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches.28

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24 See the note to AS 3101.14c.
26 Ibid.
27 Ibid.
FREQUENTLY ASKED QUESTIONS ABOUT CAMs

Audit committee members and others have expressed common initial questions and/or concerns regarding the communication of CAMs in the auditor’s report, including the following:

1. What impact will CAMs have on the communication between the auditor and audit committee?

The source of CAMs are those matters communicated or required to be communicated to the audit committee. PCAOB auditing standards already require a wide range of topics to be discussed and communicated with the audit committee, which in most cases means most, and likely all, of the matters that will be CAMs are already being discussed with the audit committee. However, not every topic that is discussed with the audit committee will rise to the level of a CAM. The PCAOB Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing.29

2. Could a significant deficiency in internal control be a CAM?

The determination that there is a significant deficiency in internal control over financial reporting cannot be a CAM because such determination in and of itself is not related to an account or disclosure.30 However, a significant deficiency could be among the principal considerations that led the auditor to determine a matter is a CAM. For example, if a significant deficiency was among the principal considerations in determining that revenue recognition was a CAM, then the auditor could describe the relevant control-related issues over revenue recognition in the broader context of the CAM without using the term significant deficiency.31

3. What types of matters will rise to the level of CAM?

CAMs may often relate to the significant risk areas of the audit. However, it is important to note that all significant risks may not be CAMs, as not every significant risk involves especially challenging, subjective, or complex auditor judgment. Likewise, the PCAOB standard does not limit the population of potential CAMs to significant risks, as several other factors (as described previously) are taken into consideration in identifying CAMs.

4. Will CAMs only relate to the current audit period?

The PCAOB requires the communication of CAMs identified in the current audit period. While most companies’ financial statements are presented on a comparative basis, requiring auditors to communicate CAMs for the current period, rather than for all periods presented, will provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users will be able to look at prior years’ filings to analyze CAMs over time; however, the standard permits the auditor to choose to include CAMs for prior periods.32

5. Will the auditor be the original source of information about the company in the auditor’s CAM communication?

The new standard includes a note explaining that 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.33 The SEC stated that they believe that situations where auditors would be required to provide information about the company that management has not already made public would be exceptions, arising only in limited circumstances, and not a pervasive occurrence.34

6. What impact are CAMs expected to have on financial reporting?

Increased attention on CAMs could result in an incremental focus on aspects of management’s related disclosures. This could result in discussion between and among management, the audit committee, and the auditor on how CAMs are described, and that may have an impact on management’s consideration of the

29 See page 18 of PCAOB Release 2017-001.
30 See page 21 of PCAOB Release 2017-001.
31 See page 35 of PCAOB Release 2017-001.
33 See Note 2 to AS 3101.14.
34 See page 25 of the SEC’s Order Granting Approval of Proposed Rules on the Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures From Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards (October 23, 2017).
information to disclose in the financial statements related to that particular matter. Early dialogue among auditors, management, and the audit committee will be important.

7. How many matters will likely be CAMs?

The number of matters that are reported as CAMs will depend on factors such as the complexity of the company’s financial reporting and the audit. The requirements of the new standard note that it is expected that in most audits, the auditor would determine at least one matter involved especially challenging, subjective, or complex auditor judgment.35

8. When may the introductory language for CAMs be different than what is illustrated on page 3?

The introductory language illustrated on page 3 should be modified to indicate the periods to which CAMs relate if the auditor communicates CAMs for prior periods.36 Also, in situations in which the auditor determines there are no CAMs,37 the auditor would replace the illustrated language on page 3 with the language illustrated below.

**Critical Audit Matters**

Critical audit matters are matters arising from the current period audit of the financial statements 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) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.38

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**What’s Next?**

Although this publication is intended as a first step in raising awareness about the underlying requirements of CAMs, it is only the beginning of the dialogue. As of this publication’s release, implementation of the CAM requirements is in its early days; many audit firms are performing dry runs. The dry runs are intended to both support the development and finalization of their methodology for determining and communicating CAMs, and engage management and audit committees in the dialogue regarding the determination and communication of CAMs. In addition, the PCAOB has committed to performing post-implementation reviews of the new standard. We encourage audit committees and other stakeholders to remain engaged in understanding what the reporting of CAMs may look like in the future.

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35 See the note to PCAOB AS 3101.12.
36 See the note in AS 3101.15.
37 AS 3101.12 states that it is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.
38 See AS 3101.16.
DEFINITION OF A CAM/KAM

Both the PCAOB and IAASB standards require CAMs/KAMs to be selected from matters communicated to audit committees or those charged with governance. As defined, CAMs must relate to accounts or disclosures that are material to the financial statements. The application guidance in paragraph A29 of International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* (ISA 701), outlines other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter. These considerations include the importance of the matter to the intended users’ understanding of the financial statements as a whole and, in particular, its materiality to the financial statements.

<table>
<thead>
<tr>
<th>PCAOB Standard</th>
<th>IAASB Standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Critical Audit Matter:</td>
<td>Key Audit Matters:</td>
</tr>
<tr>
<td>Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that</td>
<td>Key audit matters are those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period.</td>
</tr>
<tr>
<td>► relates to accounts or disclosures that are material to the financial statements, and</td>
<td>Key audit matters are selected from matters communicated with those charged with governance.</td>
</tr>
<tr>
<td>► involved especially challenging, subjective, or complex auditor judgment.</td>
<td></td>
</tr>
</tbody>
</table>
DETERMINING WHETHER A MATTER IS A CAM/KAM

A CAM is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment. The PCAOB standard provides a non-exclusive list of six factors for the auditor to consider when determining if a matter involved especially challenging, subjective, or complex auditor judgment. ISA 701 includes a judgment-based decision-making framework to help auditors determine which matters are KAMs. In addition, the PCAOB and IAASB standards state the following regarding determining CAMs and KAMs:

<table>
<thead>
<tr>
<th>PCAOB Standard</th>
<th>IAASB Standard(^{39})</th>
</tr>
</thead>
<tbody>
<tr>
<td>In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors as well as other factors specific to the audit:</td>
<td>The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:</td>
</tr>
<tr>
<td>(a) The auditor’s assessment of the risks of material misstatement, including significant risks</td>
<td>(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised)(^{40})</td>
</tr>
<tr>
<td>(b) The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty</td>
<td>(b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty</td>
</tr>
<tr>
<td>(c) The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions</td>
<td>(c) The effect on the audit of significant events or transactions that occurred during the period. (Paragraph 9 of ISA 701)</td>
</tr>
<tr>
<td>(d) The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures</td>
<td>The auditor shall determine which of the matters determined in accordance with paragraph 9 were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters. (Paragraph 10 of ISA 701)</td>
</tr>
<tr>
<td>(e) The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter</td>
<td></td>
</tr>
<tr>
<td>(f) The nature of audit evidence obtained regarding the matter</td>
<td></td>
</tr>
<tr>
<td>Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. (Paragraph 12 of AS 3101)</td>
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</tr>
</tbody>
</table>

\(^{39}\) The application guidance in ISA 701 (paragraphs A9 through A30) also introduces concepts and factors to consider when determining if a matter is a KAM. 
\(^{40}\) ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
**DESCRIPTION OF A CAM/KAM**

The description of a CAM/KAM according to both the PCAOB and IAASB standards should avoid boilerplate language. The description should provide entity- and audit-specific information on that matter but limit the use of highly technical accounting and auditing terms. Introductory language is required to be included under both the PCAOB and the IAASB approaches to explain that the CAM/KAM communications are not providing piecemeal opinions on separate elements of the financial statements.

<table>
<thead>
<tr>
<th><strong>PCAOB Standard</strong></th>
<th><strong>IAASB Standard</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>For each critical audit matter communicated in the auditor’s report, the auditor must</td>
<td>The description of each key audit matter in the Key Audit Matters section of the auditor’s report shall include a reference to the related disclosures, if any, in the financial statements and shall address:</td>
</tr>
<tr>
<td>▶ identify the critical audit matter,</td>
<td>▶ why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and</td>
</tr>
<tr>
<td>▶ describe the principal considerations that led the auditor to determine that the matter is a critical audit matter,</td>
<td>▶ how the matter was addressed in the audit.</td>
</tr>
<tr>
<td>▶ describe how the critical audit matter was addressed in the audit, and</td>
<td>(Paragraph 13 of ISA 701)</td>
</tr>
<tr>
<td>▶ refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.</td>
<td></td>
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</table>

(Paragraph 14 of AS 3101)

Note: In describing how the critical audit matter was addressed in the audit, the auditor may describe (1) the auditor’s response or approach that was most relevant to the matter, (2) a brief overview of the audit procedures performed, (3) an indication of the outcome of the audit procedures, and (4) key observations with respect to the matter, or some combination of these elements.

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41 Also see the IAASB’s application guidance in ISA 701.A46, which notes that the auditor may describe the following in a KAM: aspects of the auditor’s response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement; a brief overview of the procedures performed; an indication of the outcome of the auditor’s procedures; or key observations with respect to the matter, or some combination of these elements.
CONTENTS

From the Chair .................................................................................................................. 1

Future Meetings .................................................................................................................. 3

Recent Developments ......................................................................................................... 4

Nguyen v. View, Inc.: The Delaware Court of Chancery
Holds That Acts Deliberately Rejected by Stockholders
Are Not Subject to Ratification under Section 204
of the Delaware General Corporation Law ................................................................. 4

Reflections on the Second Circuit’s Marblegate Decision ............................................ 7

Will the PCAOB’s New Audit Report Standard Affect
Audit Letter Practice? ...................................................................................................... 13

Legal Opinion Reports ........................................................................................................ 16

Chart of Published and Pending Reports ........................................................................ 17

Membership ...................................................................................................................... 20

Next Newsletter ................................................................................................................ 20
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. 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.”

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.” 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.

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.”

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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.


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

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

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 https://www.americanbar.org/content/dam/aba/migrated/poladv/letters/attyclient/2010sep20_fasb_c.authcheckdam.pdf. The FASB dropped this project in 2012.
be CAMs. 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.” 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 Committees, to require the auditor to “provide to and discuss with the audit committee a draft of the auditor’s report.” 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.  

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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."

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.)

* Mr. White is the former Chair (2013-16) of the Audit Responses Committee of the Business Law Section of American Bar Association.
On October 23, 2017, the Securities and Exchange Commission approved the Public Company Accounting Oversight Board’s revised auditing standard, AS 3101, governing the contents and form of the audit report. As noted by SEC Chairman Jay Clayton, the new auditing standard “requires significant enhancements to certain public company audit reports, including the communication of critical audit matters (‘CAMs’) and the disclosure of auditor tenure. These changes are intended to make the auditor’s report more informative.” The SEC approved the new auditing standard in the form approved by the PCAOB in June. (See our June 2, 2017 post)

The most important change to the audit report is the requirement for the auditor to discuss CAMs. CAMs are defined as matters arising from the audit that were communicated or required to be communicated to the audit committee and that (a) relate to “accounts or disclosures that are material to the financial statements” and (b) involved “especially challenging, subjective, or complex auditor judgment.” As stated by the PCAOB, CAMs disclosure is designed to provide investors and other financial statement users with the auditors’ perspective on some of the most difficult judgments made during the audit.

The SEC received approximately 50 comment letters on the proposed auditing standard. The SEC’s Release addresses many concerns raised by commenters, including the following with respect to CAMs:

- **Boilerplate Disclosure.** In response to concerns that the audit report will devolve into a recitation of “unnecessary CAMs or boilerplate CAMs,” the SEC Release suggests that “the focus on auditor judgment in the definition of CAMs, along with the requirement to disclose why a matter is a CAM and how it was addressed, should mitigate the extent to which expanded auditor reporting could become standardized.” In light of the number of elements that must be satisfied before a matter becomes a CAM, “[t]he communication of CAMS should not be numerous and boilerplate and will provide additional information about the audit—and from the auditor’s own unique perspective—that will be useful to investors and
other financial statement users in assessing a company’s financial reporting and making capital allocation and voting decisions.”

Original Information. Some commenters expressed concern that the auditor could potentially disclose original information not included in the company’s own disclosure, including potentially material or confidential information. In response to such concerns, the SEC Release notes that the new auditing standard includes a materiality qualifier and notes that the new standard provides that “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 critical audit matter or how the matter was addressed in the audit.” The SEC Release goes on to note that “to the extent original information would need to be communicated in a CAM, we anticipate that the auditor, management, and the audit committee will engage in a dialogue about that communication.”

Audit Committee Communications. Concerns were also raised regarding the potential chilling effect of CAM reporting on the audit committee’s role and on communications among the audit committee, the auditor and management. In particular, some commenters suggested that auditors might avoid raising issues with the audit committee so as not to trigger CAM reporting. Noting that the auditing standard regarding audit committee communications (AS 1301) requires auditors to communicate many matters to the audit committee, the SEC observed that it would be “highly unusual for a matter to meet the definition of a CAM and not be required to be communicated to the audit committee.” Further, the SEC Release notes that the new auditing standard is intended to supplement the role of the audit committee, concluding that the new standard is “unlikely to impact this relationship or the dialogue between audit committees and auditors, and may even encourage audit committees to engage more extensively with auditors given that there will be disclosures by the auditor about those aspects of the audit that constitute CAMs.”

With respect to the last concern, Mr. Clayton’s separate statement said, “The audit committee’s key role in the oversight of the audit and the auditor, and in the integrity of a company’s accounting and financial reporting processes, has significantly enhanced financial reporting quality. Impairing or otherwise negatively affecting the work of well-functioning audit committees could have significant adverse effects on investors.” He added that he “would be disappointed” if the new standard “resulted in frivolous litigation costs, defensive, lawyer-driven auditor communications, or antagonistic auditor-audit committee relationships— with Main Street investors ending up in a worse position than they were before.”

Mr. Clayton also urged those implementing the revised auditing standard to “pay close attention to these issues going forward, including carefully reading the guidance provided in the approval order and the PCAOB’s adopting release.” He emphasized that the PCAOB intends to monitor the results of implementation, including consideration of unintended consequences. The SEC staff has been directed to assist in this post-implementation review process.
In addition to CAMs disclosure, the new auditing standard implements other changes to the audit report, including requiring disclosure of “the year in which the auditor began serving consecutively as the company’s auditor.” Some commenters opposed such disclosure altogether, while others suggested that disclosure in the audit report might give “undue prominence” to the information and could lead some to conclude that a correlation exists between auditor tenure and independence or audit quality. The SEC rejected these concerns, concluding that “it is appropriate for this disclosure to appear in the auditor's report because it will provide for a consistent location and decrease search costs with respect to information about auditor tenure.”

The new auditing standard will become effective in phases, with the changes other than CAMs disclosure being required in audit reports for audits of fiscal years ending on or after December 15, 2017. CAMs disclosure will first be included in audit reports for audits of large accelerated filers with fiscal years ending on or after June 30, 2019 (i.e., for calendar year companies, audit reports filed in 2020), and then for audits of all other companies to which the disclosure applies with respect to fiscal years ending on or after December 15, 2020 (i.e., audit reports filed in 2021). Notably, the new CAMs disclosure requirement is not required for audits of emerging growth companies and certain other companies, though the additional changes to the auditor’s report will apply for all such audits.

While there is a long lead time before the CAMs requirement takes effect, companies and their audit committees should consider engaging with their auditors regarding how the auditors expect to implement the CAMs standard and how they expect to apply the standard in the particular circumstances of a company’s audit.