PCAOB Mandates Extensive Changes to Public Company Audit Report

By C. William (Bill) Thomas, CPA, Ph.D.

In a new audit standard issued in June 2017, the Public Company Accounting Oversight Board (PCAOB) unanimously voted to implement sweeping changes to the standard form of its prescribed audit report. These represent the first significant changes to the standard audit report in over 70 years. The new standard will require auditors to include a discussion of critical audit matters, as well as other less controversial changes. In a prepared statement, PCAOB member Steven B. Harris said that the Board's action in adopting the new standard was a direct response to calls from investors for the Board to expand disclosures in the auditor's report.

Impetus for the New Standard

The Board traced the impetus for the new audit standard to concerns that during the banking crisis of 2008, audit reports of key financial failed institutions, such as AIG, Lehman Brothers, Bear Stearns, Citigroup and Washington Mutual, contained unqualified audit opinions from their auditors despite evidence they were on the verge of collapse. Had auditors communicated more information about their observations during their audits, investors might have had a clearer picture of the financial state of those companies.

What Keeps Us Awake at Night

The most controversial required standard report language will be addition of critical audit matters (CAMs) arising from the audit of the most recent period's financial statements. A CAM is any matter communicated to the audit committee that both relates to material accounts or disclosures, and that involves "especially challenging, subjective or complex auditor judgment." CAMs relate to "areas that have historically been of particular interest to investors, such as significant management estimates and judgments, significant unusual transactions, and other areas that pose high financial statement and audit risk." In other words, CAMs involve matters that "kept the auditor awake at night." These matters are determined subjectively by the auditor and require significant judgment on the auditor's part.

While the measure was unanimously approved by PCAOB, some members expressed qualms about it. Harris, for example, stated he was bothered by the "element of subjectivity" in defining CAMs under the standard. Harris speculated that allowing auditors to decide what matters involved "especially challenging, subjective or complex auditor judgment" grants them too much discretion. Another Board member, Lewis H. Ferguson, expressed a concern that CAM statements "will quickly deteriorate into boilerplate disclosures that are repeated year after year and over time will provide no additional useful information to financial statement users." He predicted that there would be "an inevitable attempt, on the part of audit firms with many public clients, to achieve a very high degree of uniformity in disclosure of CAMs."

To counter these potential situations, the Board has stipulated that CAMs be "tied to the factual situation of the particular audit engagement in which they arise."

Other Changes to the Standard Audit Report

Besides CAMs, the new audit standard makes other changes aimed at clarifying the auditor's role and audit responsibilities, providing more details about the auditor, and making the standard report easier to read. These other changes include:

- Auditor tenure. The new auditor's report will include a statement disclosing the year in which the auditor started serving consecutively as the company's auditor.
- Independence. The new report will include a statement that the auditor must be independent in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission (SEC) and PCAOB.
- Clarifying language. The current phrase in the scope paragraph of the audit report that describes the purpose of the audit as providing reasonable assurance as to whether the financial statements are free from material misstatement will add "whether due to error or fraud." The meaning of this phrase has only been implied in previous standards.
- Standardized form. The auditor's opinion as to the fairness of presentation of the financial statements will appear in the opening paragraph rather than the closing paragraph of the report. Also, subheadings will be added to all sections.
- Addresses. The auditor's report would be addressed to the company's shareholders and board of directors or their equivalent. Additional addressees will also be allowed.

Effective Dates

All provisions other than those related to CAMs will take effect for audits of fiscal years ending on or after Dec. 15, 2017. Provisions related to CAMs will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers and fiscal years ending on or after Dec. 15, 2020, for all other companies to which the new requirements apply.

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