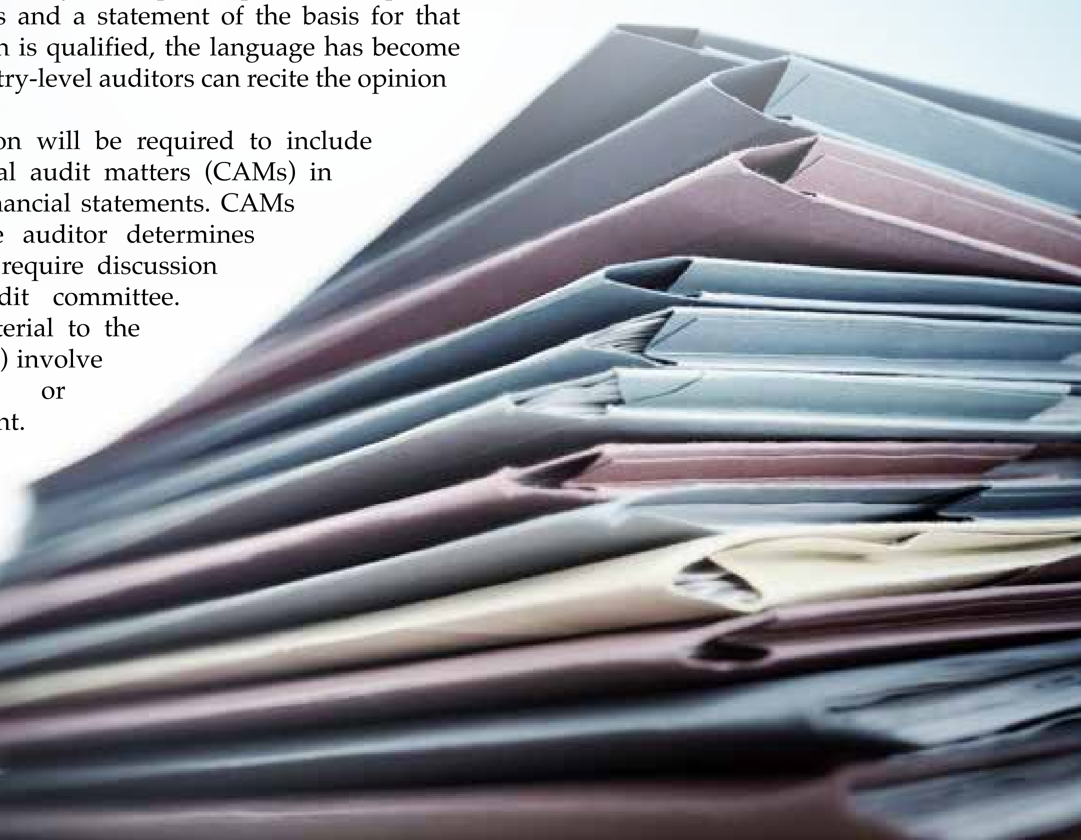
Auditor's Report is Scheduled for Remodeling

By **DON CARPENTER**, MSAcc/CPA

As with a homey den's well-worn cushions and threadbare rugs, there is a certain comfort that comes with reading the time-tested auditor's report. However, the homogenous nature of the standard (unmodified) auditor's report has rendered it almost nondescript – just a page in the package to be leafed over, necessary to be sure, but not really seen. Reader, beware – a makeover is coming.

The Public Company Accounting Oversight Board (PCAOB) released AS 3101 in June 2017 that will require a major overhaul of the auditor's report. Currently, the report expresses an opinion on the financial statements and a statement of the basis for that opinion. Unless the opinion is qualified, the language has become so boilerplate that many entry-level auditors can recite the opinion verbatim.

Prospectively, the opinion will be required to include a section describing critical audit matters (CAMs) in the audit of the current financial statements. CAMs are any matters that the auditor determines are significant enough to require discussion with the company's audit committee. These matters are (a) material to the financial statements and (b) involve challenging, subjective or complex auditor judgment.



Don Carpenter is clinical professor of accounting at Baylor University. Contact him at Don_Carpenter@baylor.edu.

AICPA's Auditing Standards Board has a similar concept called Key Audit Matters for non-public audit opinions, but the disclosure is not mandatory.

CAMs may fall within several categories:

1. An item in which estimates are critical to measurement of financial statement results, such as contingent liabilities, impairments or recognition of long-term contract losses.
2. An item for which timing of recognition is subjective, such as reserve reversals, contingent gains or tax loss/credit carryforwards.
3. An item that requires specialized skills to reflect the financial statement impact or make adequate disclosure, such as purchase price allocations, pensions accruals or environmental liabilities.

The new requirements are effective for large accelerated filers for fiscal years ending after June 30, 2019, and for all other companies for fiscal years ending after Dec. 15, 2020.

It is likely that, after initial disclosure, certain CAMs will be carried forward in successive years' reports. Actuarial assumptions for material post-retirement benefits or economic projections for goodwill impairment testing may qualify as recurring matters.

Other matters, such as the financial statement implication of a major acquisition or divestment, will generally only be included in the year of the transaction. A third category of matters may appear only sporadically, such as impairment testing for oil and gas properties, which are dependent on the ebb and flow of oil prices.

There is a presumption that every year's audit report will include at least one CAM. In addition to identifying each CAM, the report must include a description of the considerations that led the auditor to determine that an item qualified as a CAM, how the matter was addressed in the audit and a reference to the financial statement accounts or disclosures that relate to the matter. The auditor's report could obviously become quite lengthy if it contains multiple CAMs.

The new requirements are effective for large accelerated filers for fiscal years ending after June 30, 2019, and for all other companies for fiscal years ending after Dec. 15. 2020. Even though companies and their audit firms will generally have at least one more reporting period before CAMs must be disclosed, it is not too early to start preparing.

Although the report is the responsibility of the auditor, firms should anticipate that their clients will have a perspective on how CAMs are described and what specific information is disclosed. At least annually, auditors typically discuss matters that require significant judgment or specialized resources with their client's audit committee. This often takes place in conjunction with the presentation of audit fees. The matters included in this discussion should be reviewed to determine if any or all of them will qualify as CAMs.

It might then be advisable to draft the CAM section of the auditor's report with these items well in advance of the fiscal year end to allow for review by the client. It would be beneficial for the client to concur that no confidential or competitive information is being disclosed unnecessarily, although ultimately it is the auditor's responsibility to determine appropriate disclosure under independence requirements.

In cases where an audit firm may have multiple clients in the same industry, the service teams should coordinate a review of the various clients' CAMs. There should be some commonality between these clients for issues that are endemic to the industry both in terms of how the auditor addresses the matter and how the matter is reflected within the financial statements and related disclosures.

Finally, the auditor and client should begin to discuss on a regular basis any unusual transactions or events that might not be a recurring CAM, but might qualify within a specific year. This discussion could be included in the reviews that occur in conjunction with the preparation of the unaudited quarterly financial reports.

PCAOB's intent with the overhaul of the auditor's report is to give investors more insight into how the auditor views the relevant financial statements and where even a high-quality audit may be able to provide only limited certainty on material matters. As with the remodeled den, it will be incumbent upon readers to stop and take notice of the changes and get a fresh perspective on an "old friend."