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WHITE PAPER

The PCAOB Audit Reporting Standard: What You Need to Know

Written by Greg Wilson

Introduction

In the past several decades, corporate operations have grown increasingly complex and global, even as investors and other stakeholders demand increasing transparency. Yet the auditor's report—the primary means of communication between auditors and the investing public—has remained essentially unchanged since the 1940s.

In response to these challenges, the Public Company Accounting Oversight Board (PCAOB) adopted a new audit reporting standard in June 2017 that requires 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 new standard, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, was recently approved by the Securities and Exchange Commission (SEC). This white paper will review the adopted standard and related PCAOB initiatives and discuss how the changes will impact your relationship and reporting requirements with external auditors and the audit committee.

Why did the PCAOB adopt the revised reporting standard?

Auditors must often make challenging, subjective, or complex judgments when they conduct an audit. They may evaluate calculations or models, the impact of unusual transactions, or areas of significant risk.

Although the auditor is required to communicate with the audit committee regarding many such matters, there is no obligation to share similar information with investors. Many investors and others have suggested that auditors provide additional information in the auditor's report to make the report more relevant and useful. At the same time, issuers and accounting firms have argued that it would be inappropriate for the auditor to provide financial analysis or disclosures on behalf of the company being audited.

In order to address this "information asymmetry" between investors and management, the PCAOB, which has a statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports," has new changes to the auditor's reporting standard.

Changes in the new standard

The new standard responds to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report without imposing requirements beyond the auditor's expertise or mandate.

The adopted standard includes the following significant changes to the existing auditor's report.

Critical audit matters

The standard requires communication in the auditor's report of any critical audit matters (CAMs) arising from the audit of the current period's financial statements. A CAM is any matter that was communicated or required to be communicated to the audit committee and:

- Relates to accounts or disclosures that are material to the financial statements
- Involves especially challenging, subjective, or complex auditor judgment

The process of addressing CAMs involves three steps:

1. *Determination of any critical audit matters*
   The auditor would consider a nonexclusive list of factors in determining whether a matter involved especially challenging, subjective, or complex auditor judgment, such as the auditor's assessment of the risks of material misstatement.

2. *Communication in the auditor's report*
   The auditor would identify the CAM, describe the principal considerations that led to determining that the matter is a CAM, describe how it was addressed in the audit, and refer to the relevant financial statement accounts or disclosures. If there are no CAMs, the auditor would state so in his or her report.

3. *Documentation of each*
   The auditor would document each matter that was communicated or required to be communicated to the audit committee and related to accounts or disclosures that are material to the financial statements, whether or not the matter was determined to be a CAM, and the basis for such determination.

The inclusion of CAMs in the auditor's report was the subject of extensive discussion during the PCAOB's outreach as the standard was developed over the last several years. In its release of the adopted standard (PCAOB Release No. 2017-001), the PCAOB said that "Investor, investor advocate, and analyst commenters generally supported the reproposed requirements."

Many of these positive comments cited the relevance of CAMs to investors and other financial statement users in focusing attention on issues that would be pertinent to understanding the financial statements and enhancing investor confidence.

The release goes on to state that the larger accounting firms and some smaller ones generally supported including CAMs in the auditor's report with some modification of the reproposed requirements. Opposition to the inclusion of CAMs largely came from smaller accounting firms and audit committee members. They expressed concern that CAMs "would not provide relevant information to investors, may be duplicative of the company's disclosure, may result in disclosing information not otherwise required to be disclosed, could increase cost, or could delay completion of the audit."

The standard requires communication in the auditor's report of any critical audit matters (CAMs) arising from the audit of the current period's financial statements.

Additional improvements to the auditor's report

In addition to addressing critical audit matters, the new standard includes other improvements to the existing auditor's report, primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements and to make the auditor's report easier to read.

- *Clarifications of existing auditor responsibilities:* The standard enhances certain standardized language in the auditor's report, including the addition of a statement about auditor independence and the phrase "whether due to error or fraud" when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements.

- *Tenure:* The standard adds a basic element of the auditor's report related to auditor tenure.

- *Standardized report form:* Additionally, the standard requires that the opinion be the first section of the auditor's report and that section titles be included to guide the reader.

The revised standard would retain the pass/fail model of the existing auditor's report, which is generally acknowledged to be a useful signal as to whether the audited financial statements are presented fairly.

The new standard will be phased in to allow time for all involved in the financial reporting process to prepare for these new disclosures:

- 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 requirements apply.

The later effective dates for the communication of CAMs provide accounting firms, management, and audit committees more time to prepare for implementation of those requirements that are expected to require more effort to implement than the other improvements to the auditor's report.

Form AP: Auditor Reporting of Certain Audit Participants

Apart from the revised reporting standard, the PCAOB adopted new rules and related amendments to its auditing standards (subsequently approved by the SEC) of which the audit committee, management, and internal audit should be aware.

These rules, adopted in 2015, were intended to provide investors and others with information about engagement partners and accounting firms that participate in the audits of public companies. Under the new rules, registered accounting firms will be required to file a new Form AP for each audit disclosing:

- The name of the engagement partner
- The name, location, and extent of participation of each accounting firm participating in the audit whose work constitutes 5 percent or more of total audit hours
- The number and aggregate extent of participation of all other accounting firms participating in the audit whose individual participation was less than 5 percent of total audit hours

The information will be filed on Form AP, Auditor Reporting of Certain Audit Participants, and will be available in a searchable database called AuditorSearch on the PCAOB website. Users can search the database by engagement partner, audit firm, or public company, find the name of the engagement partner on a specific audit of a public company, and discover the name, location, and extent of participation of other audit firms.

While the new PCAOB standard and Form AP are aimed specifically at external auditors, they also have repercussions for the audit committee, management, and internal audit.

Practically speaking, this allows investors to see the affiliated and unaffiliated participants in an audit to gain a clearer sense of the overall quality based on the reputation of individual participants. The database includes information about firms involved in the audit effective for audit reports issued after June 30, 2017.

Effects on public companies

While the revised PCAOB standard and Form AP are aimed specifically at external auditors, they also have repercussions for the audit committee, management, and internal audit. In reviewing the impact on each of the three, it can be helpful to consider technology solutions that can streamline information retention, exchange, and discovery.

1. *Audit committee*
   Additional disclosures in the auditor's report will likely involve more extensive discussion with the audit committee on the nature of risk assessments, identification, and disclosure of CAMs, as well as the disclosure of auditor tenure. Dashboard-style technology can facilitate the discussion by providing a visual representation of risk assessments, CAMs, and other analyses while also allowing drill-down to the underlying data.

   In addition, audit committees will want to be aware of matters published in the PCAOB's AuditorSearch involving the name of the engagement partner and the names of the individual firms participating in the audit. The company should have a means of automatically querying the PCAOB database or at least storing the relevant information it provides.

The audit committee should also assess what other information it wants or needs. For example:

- A company that has operations around the world may want to understand the quality control procedures and PCAOB inspection results of affiliated firms involved in the audit in various foreign jurisdictions.

- A company that has operations in another country may have had audit work performed by an international affiliate of the auditor signing the report, but has not had it inspected by the PCAOB. The audit committee may want the auditor to explain what has been done to ensure the quality of audit work performed by the international affiliate firm.

- Understanding the number of audits the partner is responsible for may prompt discussion of whether the engagement partner has sufficient time to devote to the audit engagement and how this may affect overall audit quality.

- If the engagement partner has been associated with restatements or other anomalies on other audits, the audit committee may want to consider that when appointing an external auditor.

Finally, the audit committee will want to consider the impact of the PCAOB's new auditing standard on proxy-related disclosures. For instance, a recent survey by the EY Center for Board Matters found that from 2012 through 2017, the percentage of survey participants disclosing the length of the external auditor's tenure increased from 27 percent to 67 percent.

Similarly, for the same survey period, the percentage of survey participants that disclose whether their audit committees consider the impact of changing auditors when assessing whether to retain the current auditor increased from 3 percent to 60 percent. It seems likely these kinds of disclosures may increase, in part, as a result of the new changes to the auditor's repowering model.

2. *Management*

   Management should take the time to understand the new disclosures required under the standard as well as the specific CAMs the company's external auditor intends to identify in its report. In the early years of adoption of the standard, management will want to ensure that disclosure of CAMs is consistent with other disclosures in the financial statements, footnotes, and other disclosures in SEC filings. Advanced document storage and linking technology can simplify the process of tying CAMs disclosure to the financials and footnotes.

   Investor relations staff should consider whether any of the new audit reporting items affect investor communications. For example, disclosure of auditor tenure may prompt questions from shareholders that investor relations and management should be prepared to address.

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3. *Internal audit*

   Internal audit has much to gain by coordinating with the company's external auditors throughout the year, and the PCAOB's new audit reporting standard is no exception. Internal audit should have a clear understanding of the nature of each CAM and how it was determined.

   Because CAMs will likely involve areas where there is a higher risk of material misstatement, internal audit should have a clear understanding of the external auditor's risk assessment. It is also important that internal audit ensures that policies, procedures, and internal controls in those higher risk areas are appropriately designed and operated.

   Take advantage of the phase-in period for the required disclosure of CAMs to understand how your external auditor will approach CAMs in your company's audit. Consider whether there have been control deficiencies reported in any of the audit areas to be the subject of a CAM and consider immediately remediating any such deficiencies. Finally, ensure that your internal audit approach in areas identified as CAMs is responsive to the related risks.

Internal auditors who understand how external auditors view and prioritize risk can then use that knowledge make their management programs much more valuable to the organization and the external auditor in the aggregate. Here again, a collaborative work management solution can reduce inefficiencies between external auditors and internal audit functions. With this platform, both parties can look at one source of truth to align perspectives, identify areas of concern, and prioritize risk.

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A final thought

I have heard concerns: "What happens if there is a significant deficiency identified in the audit area that is the subject of a CAM? Will the auditor, in essence, be making public disclosure of a significant deficiency in the audit report?"

My response is no. I doubt you will see the auditor use the term "significant deficiency" in the description of a CAM. However, as a practical matter, if there is a significant deficiency in an audit area identified as a CAM, it seems the disclosure of how the matter was addressed in the audit could be more extensive than a situation where there were no control deficiencies.

My advice: understand the CAMs identified by the external auditor and ensure that your underlying audit documentation in those areas is strong in both quantity and quality—and free of any control deficiencies.

Additional reading

For additional reading on the reporting standard, including examples of the auditor's unqualified report and the communication of critical audit matters, please see:

- PCAOB Release No. 2017-001, June 1, 2017, pages A1–17
- PCAOB Release No. 2016-003, May 11, 2016, pages 32–35

About the author

Greg Wilson

Greg retired March 31, 2014, as Deputy Director in the Division of Registrations and Inspections (DRI) of the PCAOB. In 2005, Greg joined the PCAOB to build and lead the Chicago Regional Office. During this time, he led the development and oversight of inspection activities related to audits of ICFR, including the implementation of Auditing Standard No. 5. Greg served as the leader of DRI's National Office Consultations and the chair of the DRI Performance Review Committee. Prior to joining the PCAOB, he served in the audit practice at Ernst & Young and as the audit partner for a variety of global businesses. Greg graduated from the University of Illinois with a B.S. in accountancy and is a member of the AICPA and the Illinois CPA Society.

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