

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–81187; File No. PCAOB–2017–01]

### Public Company Accounting Oversight Board; Notice of Filing 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

July 21, 2017.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act" or "Sarbanes-Oxley Act"), notice is hereby given that on July 19, 2017, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

#### I. Board's Statement of the Terms of Substance of the Proposed Rules

On June 1, 2017, the Board adopted new rules and amendments to auditing standards (collectively, the "proposed rules") to make the auditor's report more informative and relevant to investors and other financial statement users. The text of the proposed rules appears in Exhibit A to the SEC Filing Form 19b–4 and is available on the Board's Web site at <https://pcaobus.org/Rulemaking/Pages/Docket034.aspx> and at the Commission's Public Reference Room.

#### II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements. In addition, the Board is requesting that the Commission approve the proposed rules and related amendments, with the exception of the requirements related to critical audit matters, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, for application to audits of emerging growth companies ("EGCs"),

as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act"). The Board's request is set forth in section D.

#### A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

##### (a) Purpose Summary

The Board has adopted 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."<sup>1</sup>

The Board has adopted 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,<sup>2</sup> even though investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for their benefit.<sup>3</sup> 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

<sup>2</sup> 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.

<sup>3</sup> See PCAOB IAG survey, Improving the Auditor's Report (Mar. 16, 2011) ("IAG 2011 survey"). See also CFA Institute's Usefulness of the Independent Auditor's Report Survey Results (May 4, 2011), Independent Auditor's Report Survey Results (Mar. 31, 2010), and Independent Auditor's Report Monthly Poll Results (Mar. 12, 2008) ("CFA survey and poll results"). See also Board public meeting transcripts and participant statements (Apr. 2–3, 2014), available on the Board's Web site in Rulemaking Docket Matter No. 034, Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments ("Docket 034").

<sup>1</sup> Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7211(a).

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.

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 has adopted 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.

#### (b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

#### B. Board's Statement on Burden on Competition

Not applicable.

#### C. Board's Statement on Comments on the Proposed Rules Received From Members, Participants or Others

The Board released the proposed rule amendment for public comment in *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-003 (June 21, 2011) ("concept release"), *Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor*

*Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 (Aug. 13, 2013) ("proposal"), *Proposed Auditing Standard—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2016-003 (May 11, 2016) ("reproposal"). See Exhibit 2(a)(A). A copy of Release Nos. 2011-003, 2013-005, 2016-003 and the comment letters received in response to the PCAOB's requests for comment are available on the PCAOB's Web site at <https://pcaobus.org/Rulemaking/Pages/Docket034.aspx>. The Board received 491 written comment letters. The Board's response to the comments it received and the changes made to the rules in response to the comments received are discussed below.

#### Discussion of the Final Standard

##### Critical Audit Matters

Under the final standard, the auditor will be required to communicate critical audit matters in the auditor's report in order to provide more information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users.

Investor, investor advocate, and analyst commenters generally supported the repromulgated requirement to communicate critical audit matters. Some of them stated that the communication of critical audit matters would be relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor, focusing attention on issues that would be pertinent to understanding the financial statements, and enhancing investor confidence in the financial statements.

The larger and some smaller accounting firms generally supported including critical audit matters in the auditor's report with some modification of the repromulgated requirements. Other commenters, including other smaller accounting firms, companies, and audit committee members, did not support the requirements. Some of these commenters asserted that critical audit matters 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.

Other commenters suggested that the Board align the definition of critical audit matters with the International Auditing and Assurance Standards Board's ("IAASB") definition of key audit matters to enhance overall consistency.

Consistent with the Board's statutory mandate under Section 101(a) of Sarbanes-Oxley and in response to the 2008 U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") recommendation and continued investor support for expanded auditor reporting, the final standard includes the requirement to communicate critical audit matters substantially as repropoed. The Board has taken into consideration all comments, including concerns raised by some commenters, which are described in more detail below, 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. 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 those matters.

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. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

#### Determination of Critical Audit Matters

##### Definition of Critical Audit Matter

The repropoed standard defined a critical audit matter as 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*. For the reasons explained below, the Board is adopting the definition as repropoed.

##### Communicated or Required To Be Communicated to the Audit Committee

Most commenters agreed that matters communicated or required to be communicated to the audit committee would be the appropriate source for critical audit matters. These

commenters stated that matters communicated to the audit committee are the most meaningful to users of the financial statements and using them as the source of critical audit matters would assist the auditor in determining critical audit matters in the most efficient and effective manner.

PCAOB standards require the auditor to communicate to the audit committee, among other things:

- Significant risks identified by the auditor;
- Certain matters regarding the company's accounting policies, practices, and estimates;
- Significant unusual transactions;
- Certain matters regarding the auditor's evaluation of the company's relationships and transactions with related parties; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Several commenters suggested revising the source of critical audit matters. Some suggested narrowing the source of critical audit matters only to matters required to be communicated to the audit committee, on the basis that this would avoid chilling communications regarding non-required matters and reduce the burden of documentation. Other commenters suggested that the Board consider, as an alternative, selecting critical audit matters only from critical accounting policies and estimates disclosed by management, which some said would eliminate the potential for the auditor to become the original source of information, as well as the potential for conflicting disclosures between the auditor and management. Some commenters also recommended not specifying the source for critical audit matters and leaving it up to auditor judgment. Other commenters suggested broadening the source of critical audit matters to include matters documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated with management and other members of the board of directors, as the Board had originally proposed in 2013.

The final standard retains the source of critical audit matters as repropoed. Critical audit matters will be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). The source will include auditor communication requirements under AS 1301, *Communications with Audit Committees*, other PCAOB rules

and standards,<sup>4</sup> and applicable law,<sup>5</sup> as well as communications made to the audit committee that were not required. This approach scopes in the broadest population of audit committee communications and will not require the auditor to determine whether matters communicated to the audit committee were required to be communicated. However, it seems likely that matters that meet the definition of a critical audit matter will usually relate to areas that are required to be communicated to the audit committee, either under a specific communication requirement or the broad provisions of paragraph .24 of AS 1301, which requires communication of matters arising from the audit that are significant to audit committee oversight of the financial reporting process.

Required communications to the audit committee generally include the areas in which investors have expressed particular interest in obtaining information in the auditor's report, 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 does not limit the source of critical audit matters to critical accounting policies and estimates because the Board does not believe this would be an appropriate starting point in light of investor interest in a broader range of topics related to the audit. Additionally, the final standard does not broaden the source, as proposed in 2013, to also include matters documented in the engagement completion document and reviewed by the engagement quality reviewer because it is unlikely that a matter that is determined to be a critical audit matter would not have already been communicated to the audit committee.

Some commenters suggested that using audit committee communications as the source for critical audit matters could impair the relationship between auditor, management, and the audit committee (e.g., chill communications, give rise to conflict, or cause auditors to communicate more than they otherwise would). However, other commenters argued that critical audit matters would

<sup>4</sup> See Appendix B of AS 1301, which identifies other PCAOB rules and standards that require audit committee communication, such as AS 2410, *Related Parties*, and AS 2502, *Auditing Fair Value Measurements and Disclosures*.

<sup>5</sup> See, e.g., Section 10A(k) of the Exchange Act, 15 U.S.C. 78j-1(k); Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Exchange Act Rule 10A-3, 17 CFR 240.10A-3.

enhance, not impair, communications between auditors, investors, and those charged with governance (including audit committees). For matters required to be communicated to the audit committee, the 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. It would seem that any chilling effect would more likely relate to matters that are not explicitly required to be communicated to the audit committee, although given the broad requirements of AS 1301 (particularly paragraph .24), the Board believes that there may be few, if any, relevant communications affected by that possibility.

Some commenters suggested excluding certain required audit committee communications from the source of critical audit matters, generally because these communications relate to sensitive areas and may result in the auditor communicating information not disclosed by management. Suggestions included: Corrected and uncorrected misstatements, qualitative aspects of significant accounting policies and practices, alternative treatments within generally accepted accounting principles (“GAAP”) for policies and practices related to material accounts, violations or possible violations of law or regulation, independence considerations, disagreements with management, other material written communications between the auditor and management, overall planned audit strategy, delays encountered in the audit, and competency issues of management. Other commenters argued that no audit committee communications should be specifically excluded from consideration as a source of potential critical audit matters.

The final standard does not exclude any required audit committee communications from the source of critical audit matters. To the extent that any such communication met the critical audit matter definition (including that it (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment), the Board believes it will be an appropriate subject for an auditor to communicate as a critical audit matter.

#### Relates to Accounts or Disclosures That Are Material to the Financial Statements

The materiality component of the reproposed definition of critical audit matters—that the matter “relates to accounts or disclosures that are

material<sup>6</sup> to the financial statements”—was intended to respond to investor requests for informative and relevant auditor’s reports while, at the same time, addressing other commenters’ concerns regarding auditor communication of immaterial information that management is not required to disclose under the applicable financial reporting framework and SEC reporting requirements.

Some investor commenters suggested removing the materiality component of the reproposed definition of critical audit matters, arguing that it made the definition too narrow and would unnecessarily exclude relevant information. Some of these commenters observed that many cases of material accounting problems or fraud started as “immaterial” to the financial statements and built over time, and that such matters may not meet the reproposed definition of a critical audit matter because of the materiality component.

Other commenters, primarily companies and accounting firms, argued that the reproposed definition was too broad and suggested modifying the materiality component such that a critical audit matter would itself have to be material to the financial statements as a whole, rather than relating to accounts or disclosures that are material to the financial statements. These commenters expressed concern that the phrase “relates to accounts or disclosures that are material to the financial statements” could apply to too many matters, resulting in the auditor disclosing immaterial matters that would not otherwise be disclosed by management, or give the impression of a piecemeal opinion.

After consideration of comments, the Board has determined to adopt the materiality component in the final definition of critical audit matter as reproposed. In the Board’s view, the purpose of the standard—making the auditor’s report more useful and informative to investors—is better served by auditor communication of matters related to accounts or

<sup>6</sup> The definition of materiality is established under the U.S. federal securities laws. In interpreting those laws, the U.S. Supreme Court has held that a fact is material if there is “a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” See *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). See also *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988). As the Supreme Court has further explained, determinations of materiality require “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him . . .” *TSC Industries*, 426 U.S. at 450.

disclosures that are material to the financial statements. As one commenter noted, limiting the source of critical audit matters and adding a materiality component that directly relates to accounts and disclosures “would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of [critical audit matters] within the auditor’s report that could deemphasize their importance.”<sup>7</sup>

At the same time, in the Board’s view, limiting critical audit matters to those that are, in and of themselves, material to the financial statements as a whole would not serve the intended purpose of the standard. If the auditor were required to determine that a critical audit matter itself is material, rather than related to an account or disclosure that is material, it is likely that fewer matters would meet the definition of a critical audit matter and, thus, investors would likely receive less, and less audit-specific, information than under the standard as adopted.

Accordingly, as in the reproposal, the final standard provides that each critical audit matter relates to accounts or disclosures that are material to the financial statements. Consistent with the reproposal, “relates to” clarifies that the critical audit matter could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. For example, the auditor’s evaluation of the company’s goodwill impairment assessment could be a critical audit matter if goodwill was material to the financial statements, even if there was no impairment; it 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. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. For example, the auditor’s evaluation of the company’s ability to continue as a going concern could also represent a critical audit matter depending on the circumstances of a particular audit.

On the other hand, a matter that does not relate to accounts or disclosures that are material to the financial statements

<sup>7</sup> See letter from Dixon Hughes Goodman, LLP (Aug. 15, 2016) at 2, available on the Board’s Web site in Docket 034 (also noting that there is a continuing risk that the auditor could disclose information about the company that was not previously disclosed by the company).

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. The same rationale would apply to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements; the matter would not relate to an account or disclosure that is material to the financial statements.

For the same reason, the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, cannot be a critical audit matter; such determination, in and of itself, does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. A significant deficiency could, however, be among the principal considerations that led the auditor to determine that a matter is a critical audit matter.<sup>8</sup>

#### Involved Especially Challenging, Subjective, or Complex Auditor Judgment

Many commenters supported including “matters that involved especially challenging, subjective, or complex auditor judgment” in the repropoed definition of a critical audit matter. Other commenters argued that the phrase “especially challenging, subjective, or complex auditor judgment” is broad and subjective and would lead to inconsistent application of the repropoed definition. For example, some commenters said that critical audit matters would vary based on the experience and competence of the auditor, even if the underlying facts and circumstances were the same. One commenter urged disclosure of the auditor’s perspective on material related party transactions. Another commenter suggested that the standard include a note stating that it is expected that in most audits, financial statement matters involving the application of significant judgment or estimation by management would involve especially challenging, subjective, or complex auditor judgment.

<sup>8</sup> See below for additional considerations related to auditor disclosure of original information.

Several commenters suggested using the IAASB’s definition of key audit matters, which includes those matters that were of most significance in the audit of the financial statements and that required significant auditor attention. One commenter argued that this would avoid reliance on the auditor’s determination of whether a matter involved especially challenging, subjective, or complex auditor judgment, which the commenter said would give auditors too much discretion.

After consideration of comments, the Board is adopting this component of the definition of critical audit matter as repropoed, namely “matters that involved especially challenging, subjective, or complex auditor judgment.” This grounds the definition in the auditor’s expertise and judgment, which is directly responsive to investor requests for information from the auditor’s point of view. Thus, the Board believes that this definition will focus critical audit matters in areas where investors will particularly benefit from expanded reporting by the auditor.

The determination of critical audit matters is principles-based and the final standard does not specify any items that would always constitute critical audit matters. For example, the standard does not provide that all matters determined to be “significant risks” under PCAOB standards would be critical audit matters.<sup>9</sup> Some significant risks may be determined to be critical audit matters, but not every significant risk would involve especially challenging, subjective, or complex auditor judgment. To illustrate, improper revenue recognition is a presumed fraud risk and all fraud risks are significant risks;<sup>10</sup> however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it will not be a critical audit matter. Similarly, the final standard does not provide, as some commenters suggested, that material related party transactions or matters involving the application of significant judgment or estimation by management always constitute critical audit matters. The auditor must determine, in the context of the specific audit, that a matter involved especially challenging, subjective, or complex auditor judgment. In addition, focusing on auditor judgment should limit the extent to which expanded auditor

<sup>9</sup> A significant risk is a “risk of material misstatement that requires special audit consideration.” Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

<sup>10</sup> See AS 2110.71.

reporting could become duplicative of management’s reporting. To the extent that critical audit matters reflect differences in auditors’ experience and competence, this in itself should also be informative.

#### Factors

The repropoal included the following nonexclusive list of factors for the auditor to take into account, together with audit-specific factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

- a. The auditor’s assessment of the risks of material misstatement, including significant risks;
- b. The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
- c. 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;
- d. 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;
- e. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and
- f. The nature of audit evidence obtained regarding the matter.

Commenters in general agreed that including such factors would assist the auditor in determining critical audit matters.

Some commenters suggested changes to better align the factors with areas of complex management judgment, to reduce the risk that the auditor would be the source of original information, to clarify the linkage of procedures performed by the auditor and sufficient appropriate audit evidence obtained in performing those procedures, and to focus the auditor on the audit procedures executed to obtain sufficient and appropriate audit evidence rather than audit strategy decisions. Some commenters suggested harmonizing the factors with the IAASB’s factors for determining key audit matters.

After considering the comments received, the Board has modified the factors by reordering them and revising the factor relating to the degree of auditor subjectivity (factor b above) to refer to the application (rather than determination) of audit procedures, which focuses it more clearly on the

performance of the audit rather than audit strategy.

Some commenters suggested that the factor pertaining to the nature and extent of the audit effort (factor c) be revised to relate to the nature and extent of audit effort required to obtain sufficient appropriate audit evidence to address a matter and the factor pertaining to the nature of audit evidence (factor f) be deleted to clarify that obtaining audit evidence is a component of audit effort. The final standard does not change factor c as suggested because it would inappropriately narrow the factor exclusively to considerations related to obtaining audit evidence rather than the nature of the overall audit effort. Additionally, the Board determined to retain factor f as a stand-alone factor because, as stated in the reproposal, in the limited implementation trial conducted by several accounting firms, this factor appeared to be one of the most useful in determining critical audit matters.<sup>11</sup>

A commenter recommended including a factor based on the extent of interaction with the audit committee. The final standard does not include this factor because the extent of interaction might not be a meaningful indicator of the complexity or subjectivity of the matter and it could create incentives to limit communication between the auditor and the audit committee.

One commenter did not agree with elimination of two proposed factors that related to the severity of control deficiencies and corrected and uncorrected misstatements. These factors were eliminated from the reproposal in response to comments that the factors would lead the auditor to determine matters as critical audit matters in areas where the company has no existing reporting obligation, or where the company has determined that the matters are not material and therefore do not require disclosure under the financial reporting framework. For these reasons, the final standard does not include these factors.

Under the final standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts or disclosures that are material to the company's financial statements, the auditor should take into account the following nonexclusive list of factors, as well as other audit-specific factors, when determining whether a matter involved

especially challenging, subjective, or complex auditor judgment:

- 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.

The determination should be made in the context of the particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks. The factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective, or complex auditor judgment. Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on one or more of these factors, other factors specific to the audit, or a combination.

#### Audit Period Covered by Critical Audit Matters

The reproposal would have required the auditor to communicate critical audit matters for the audit of the current period's financial statements. Because the communication of critical audit matters for prior periods might also be useful to investors and other financial statement users in certain situations, the repropose standard provided that the auditor may communicate critical audit matters relating to a prior period 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.

Some commenters generally supported communicating critical audit matters for only the current period's financial statements or for all periods if audited financial statements have not

been made public previously. Other commenters supported communication of critical audit matters for all periods presented along with an explanation if prior year critical audit matters are not repeated in the current year. Yet another commenter stated that the auditor should be encouraged to use judgment as to whether to include critical audit matters for prior periods and not limit the consideration only to the circumstances described in the reproposal.

The final standard retains the requirement to communicate critical audit matters only for the current audit period. While most companies' financial statements are presented on a comparative basis, and thus most auditor's reports cover a similar period, requiring auditors to communicate critical audit matters 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 critical audit matters over time. However, the auditor could choose to include critical audit matters for prior periods. The final standard clarifies that the two situations relating to a prior period are examples rather than the only situations in which a critical audit matter for a prior period may be communicated.

As noted in the reproposal, if the auditor's report is dual-dated, the auditor will determine whether the new information for which the auditor's report is dual-dated gives rise to any additional critical audit matters.

In situations in which a predecessor auditor has been asked to reissue its auditor's report, the communication of critical audit matters for the prior period need not be repeated because it is only required for the current year. However, the predecessor auditor could choose to include prior year critical audit matters in the reissued auditor's report.

#### Requirements of Other Regulators and Standard Setters

*IAASB.* Under the IAASB's standard, "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 determined using a two-step process. First, the auditor identifies the matters communicated

<sup>11</sup> See letter from the Center for Audit Quality (June 19, 2014) at 5, available on the Board's Web site in Docket 034.

with those charged with governance<sup>12</sup> that required significant auditor attention in performing the audit, taking into account:

- Areas of higher assessed risks of material misstatement, or significant risks;
- 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; and
- The effect on the audit of significant events or transactions that occurred during the period.<sup>13</sup>

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters.<sup>14</sup> The IAASB requires the communication of key audit matters for the current period only.<sup>15</sup>

*European Union (“EU”).* The EU requires the auditor to describe the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud.<sup>16</sup> The EU does not specify the period for which these need to be described.

*Financial Reporting Council in the United Kingdom (“FRC”).* The FRC requires the auditor 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.<sup>17</sup> The FRC does not specify the period for which these need to be described.

#### Communication of Critical Audit Matters

Under the reproposal, the auditor would have been required to include introductory language in the auditor’s report preceding the communication of critical audit matters and to communicate critical audit matters by identifying each matter, describing the auditor’s principal considerations for determining that the matter was a critical audit matter, describing how the critical audit matter was addressed in the audit, and referring to the relevant financial statement accounts and disclosures.

<sup>12</sup> See paragraph 8 of ISA 701. *See also* ISA 260, *Communication with Those Charged with Governance*, which provides requirements for auditor communications with those charged with governance.

<sup>13</sup> *See* paragraph 9 of ISA 701.

<sup>14</sup> *See* paragraph 10 of ISA 701.

<sup>15</sup> *See* paragraphs 8 and 10 of ISA 701.

<sup>16</sup> *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No. 537/2014.

<sup>17</sup> *See* paragraph 19A of UK ISA 700 (2013).

Comments varied on the repropose requirements for communication of critical audit matters and the level of detail the auditor should provide, including whether the auditor should be permitted to provide information about the company that has not been previously disclosed by the company (which commenters referred to as “original information”). Commenters generally agreed with identifying each critical audit matter and referring to the relevant financial statement accounts and disclosures. One commenter suggested removing the requirements to describe the considerations for determining that a matter was a critical audit matter and how the critical audit matter was addressed in the audit. While some commenters stated that the proposed requirements regarding auditor’s communication of critical audit matters are sufficiently clear, many suggested improvements to some of the components of the communication requirements. After consideration of comments, the Board has made some enhancements to the communication requirements, as described below.

#### Introductory Language

The repropose standard provided introductory language to be included in the “Critical Audit Matters” section of the auditor’s report indicating that critical audit matters did not alter the opinion on the financial statements and that the auditor was not providing a separate opinion on the critical audit matters. Some commenters supported the introductory language on the basis that it could minimize users’ potential misunderstanding of the critical audit matters.

Some commenters suggested additions to the introductory language to emphasize that critical audit matters are subjective and may not represent the most important aspects of the financial statements, to clarify that the description of procedures should not be taken as indicative of results of any individual procedure, or to limit reliance on critical audit matters by adding language similar to that used in a report on an audit of internal control over financial reporting (“ICFR”).<sup>18</sup> The

<sup>18</sup> The auditor’s report on the audit of internal control over financial reporting requires a paragraph stating that, “because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.” *See* paragraph .85j of AS 2201, *An Audit of Internal*

introductory language in the final standard does not include the suggested additions because such language could be interpreted as disclaiming or inappropriately minimizing the communication of critical audit matters.

Other commenters suggested minor revisions in the introductory language to refer to the “communication of critical audit matters” rather than the critical audit matters themselves. In response to this comment, the required introductory language in the final standard has been revised as follows (additions are *in italic* and deletions are in {brackets}):

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 {C}critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we {do} are not, by communicating the critical audit matters below, {provide} providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.*

#### Communication Requirements

The reproposal required that, for each critical audit matter, the auditor would:

- Identify the critical audit matter;
- Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- Describe how the critical audit matter was addressed in the audit; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

As discussed in more detail below, these requirements have been adopted substantially as repropose.<sup>19</sup>

#### *Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

<sup>19</sup> The repropose release included two illustrative examples of the communication of critical audit matters. *See* PCAOB Release No. 2016–003, Section IV.A.2.b. Given the principles-based nature of the requirements for critical audit matters and the objective of providing tailored, audit-specific information, the examples were intended to function as illustrations of how critical audit matters could be communicated, and not as templates for how critical audit matters should be communicated. Comments received on these examples were taken into account in the Board’s consideration of the final standard. Illustrative examples do not appear in the adopting release because the Board believes auditors should provide tailored, audit-specific information when communicating critical audit matters in the auditor’s report.



### Identify the Critical Audit Matter and Describe the Principal Considerations That Led the Auditor To Determine That the Matter Is a Critical Audit Matter

Many commenters who addressed this topic supported the identification of the critical audit matter and limiting the description to “the principal considerations” that led the auditor to determine that the matter is a critical audit matter, and those aspects of the communication requirements are adopted as repropoed. The auditor’s description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication will be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.

### Describe How the Critical Audit Matter Was Addressed in the Audit

The repropoed standard included a new requirement for the auditor to describe how the critical audit matter was addressed in the audit. While the standard did not specify how this should be done, the repropoing release provided four examples of potential approaches to such descriptions: (1) The auditor’s response or approach that was most relevant to the matter; (2) a brief overview of the procedures performed; (3) an indication of the outcome of the auditor’s procedures; and (4) key observations with respect to the matter, or some combination of these elements.<sup>20</sup>

Many commenters were supportive of a requirement to describe how each critical audit matter was addressed in the audit. Some commenters asserted that a description of how a critical audit matter was addressed would benefit investors by providing insights on how and on what basis the auditor developed the opinion or the rigor that underlies the audit procedures performed. For example, one investor commenter stated that including audit procedures in the description of a critical audit matter would make the auditor’s report more informative and useful. Several investors suggested that the auditor should be required or encouraged to provide informative, company-specific findings when describing how the critical audit matter was addressed in

the audit, such as whether management’s significant accounting estimates and judgments were balanced, mildly optimistic, or mildly pessimistic.

One commenter suggested that the description of how the critical audit matter was addressed in the audit should be optional. Several commenters objected to the auditor including audit procedures in the description of critical audit matters because it would not provide any incremental value or actionable information to investors, investors may not have the expertise or context to understand audit procedures, or the description of audit procedures would become boilerplate. One commenter suggested adding a note to clarify that the purpose of describing audit procedures is to provide information about the audit but not specific details that would compromise the effectiveness of audit procedures. Other commenters suggested that only the principal audit procedures should be provided.

The final standard includes the requirement for the auditor to describe how the critical audit matter was addressed in the audit because it is consistent with the Board’s objective of providing more information about the audit and, if developed with an appropriate focus on the intended audience, should be of interest to users. Similar to the repropoal, the final standard does not prescribe a specific way to meet this requirement. Several commenters suggested that the four examples provided in the repropoing release be included in the standard because they provide helpful guidance on how the requirement could be met. The final standard includes a note incorporating these examples, which should clarify the Board’s expectations while providing flexibility in describing how a critical audit matter was addressed in the audit.

While the description of how the critical audit matter was addressed in the audit will require judgment, the auditor should bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company’s financial statements that will be useful to investors. A brief overview of the audit procedures performed is one of the alternatives for describing how the critical audit matter was addressed. If the auditor chooses to describe audit procedures, the descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, as the four examples should make clear, the objective is to provide a useful summary, not to detail every aspect of

how the matter was addressed in the audit. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.

In its comment letter, a working group of the IAG stressed the importance to investors of auditor findings, which they described as “the one item that [they] believe would provide the greatest value to investors.”<sup>21</sup> Acknowledging the difficulty of mandating reporting of findings, the working group recommended that the Board encourage auditors to include them voluntarily. Under the final standard, communication of the auditor’s findings is not required; however, in describing the audit response, the auditor may choose to include findings as an indication of the outcome of audit procedures or key observations about a matter. The Board shares the working group’s view that the inclusion of informative, company-specific audit findings related to critical audit matters may, in appropriate circumstances, be valuable to investors and encourages auditors to consider including such findings in their auditor’s reports. However, in describing findings, the language used 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.

### Refer to the Relevant Financial Statement Accounts or Disclosures That Relate to the Critical Audit Matter

The repropoed standard would have required the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. There were few comments on this requirement. One commenter suggested that, to avoid duplication, reference should be made only to the disclosures and not the financial statement accounts. In response to this suggestion, the final standard clarifies that the auditor could refer to either the relevant account or disclosure, rather than both, to avoid potential duplication.

The repropoal also solicited comment on whether, in addition to referring to the relevant financial

<sup>20</sup> These elements are similar to the IAASB’s elements described in paragraph A46 of ISA 701. The EU also requires that the auditor describe key observations with respect to the most significant assessed risks of material misstatement.

<sup>21</sup> Letter from the IAG’s auditor’s report working group (Aug. 15, 2016) at 1, available on the Board’s Web site in Docket 034. The working group made a presentation regarding its comment letter at the IAG meeting in October 2016, available on the Board’s Web site.



statement accounts and disclosures, the auditor should refer to relevant disclosures outside the financial statements. Commenters that addressed this question generally opposed the auditor referencing disclosures outside the financial statements when describing a critical audit matter because it may incorrectly suggest that such information is audited or cause readers to misinterpret the auditor's role in relation to such information. The final standard only requires the auditor to refer to the relevant financial statement accounts or disclosures.

#### Additional Considerations Related to the Communication Requirements

##### Auditor Disclosure of "Original Information" About the Company

The repropoed standard included a note to indicate that, when describing critical audit matters in the auditor's report, the auditor is not expected to provide original information unless it 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.

Investor commenters, including the auditor's report working group of the IAG, argued that there should not be any limitation on the auditor providing original information and that the reproposal went too far in constraining the auditor from providing original information in response to concerns expressed by other commenters (which were primarily companies and accounting firms).

Other commenters expressed the view that auditors should not provide original information about the company or should be limited to providing information about the audit and not the company. These commenters stated that the auditor providing original information about the company would be inconsistent with the traditional U.S. regulatory framework, whereby management provides information about the company and the auditor attests to compliance with the applicable financial reporting framework. However, one investor commenter noted that auditor reporting should not be limited by "original information," a term that is undefined in auditing literature.

No PCAOB standard, SEC rule, or other financial reporting requirement prohibits auditor reporting of information that management has not previously disclosed. Rather, there are areas under current law and auditing standards that require auditor reporting that goes beyond attesting to the

compliance of management disclosures (e.g., substantial doubt about a company's ability to continue as a going concern<sup>22</sup> or illegal acts<sup>23</sup>). As discussed in more detail below, auditors may have professional or state law obligations to maintain client confidentiality, but these obligations should not apply to, or should be preempted by, reporting obligations arising under federal law and regulations, including under PCAOB standards. Accordingly, the requirement to communicate critical audit matters is not, as some commenters have suggested, inconsistent with the existing U.S. financial reporting framework and auditors' other obligations.

Commenters also said that the role of the audit committee or management would be undermined by requiring the auditor to disclose information about the company's financial statements, since in their view it is solely management's responsibility to determine what disclosure is appropriate. Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management, and that management would likely modify its disclosure in response to the communication of critical audit matters in the auditor's report so the auditor would not be a source of original information. While some commenters said that this would improve management disclosures, others said it would be an inappropriate expansion of the auditor's role or would add significant costs. Other commenters stated that companies could be harmed by the disclosure of confidential or competitively sensitive information. Another commenter expressed concern that investors could be confused or misled if auditor reporting lacked context or appeared to conflict with management disclosures. One commenter suggested that the auditor should disclose original information only if a disclosure matter continues to

be unresolved after discussion with management and the audit committee.

The Board acknowledges these concerns and, in developing the auditor's communication requirements, has sought to strike an appropriate balance between investor demands for expanded auditor reporting and the costs and potential unintended consequences associated with providing it. While auditor reporting of original information is not prohibited, it is limited to areas uniquely within the perspective of the auditor: Describing the principal considerations that led the auditor to determine that the matter is a critical audit matter and how the matter was addressed in the audit. The objective of critical audit matters—helping investors to focus on identified areas of the audit and understand how the auditor addressed them—may not be accomplished if the auditor is prohibited from providing such information. Moreover, prohibiting the auditor from providing such information could make critical audit matter communications incomplete in a way that could be confusing to or misunderstood by investors.

It seems likely, as one commenter observed, that auditors will generally not have incentives to provide information about the company that the company has not already made public. Another commenter noted that, in current practice, disclosure is already guided by an iterative process between management and the auditor, and expected that a similar process would occur for critical audit matters, reducing the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.<sup>24</sup> To the extent that an auditor's decision to communicate a critical audit matter incents the company to expand or supplement its own disclosure, the Board believes this may improve the quality of public disclosures, which would be an indirect benefit of the standard. However, if the company does not provide additional disclosure, and the information is necessary to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter or how it was addressed in the audit, the Board believes it is in the public interest for the auditor to include that information in the auditor's report. The final standard therefore retains the note from the reproposal explaining that

<sup>22</sup> See AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*. The auditor is required to include a going concern explanatory paragraph if the auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time (see AS 2415.12). If management's disclosure with respect to the company's ability to continue as a going concern is inadequate, the auditor's reporting responsibility regarding going concern remains and the report includes either a qualified or an adverse opinion (see AS 2415.14).

<sup>23</sup> Auditors may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the Exchange Act), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

<sup>24</sup> It should be noted, however, that critical audit matters are not a substitute for disclosures required of the company under the applicable financial reporting framework.

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.

Of course, any matter that will be communicated as a critical audit matter will already have been discussed with the audit committee, and the auditor will be required to provide a draft of the auditor's report to the audit committee and discuss the draft with them.<sup>25</sup> In addition, as the auditor determines how best to comply with the communication requirements, the auditor could discuss with management and the audit committee the treatment of any sensitive information.

Some commenters also stated that, in areas where there are specific reporting obligations under the applicable financial reporting framework or SEC reporting requirements but the matter falls below the disclosure threshold (for example, a significant deficiency), auditor communication could, in effect, impose a lower disclosure threshold. With regard to such areas, it is likely that the nature of a critical audit matter and its description would be broader than, for instance, focusing on a significant deficiency. In addition, while the auditor is required to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, (which may include, if relevant, information about the company's processes and controls) and how the overall matter was addressed, it is not necessary for the auditor's description to use the terminology of the other auditing standard, such as "significant deficiency" within the broader context of a critical audit matter. For example, if a significant deficiency was among the principal considerations in determining that revenue recognition was a critical audit matter, the auditor would describe the relevant control-related issues over revenue recognition in the broader context of the critical audit matter without using the term "significant deficiency."<sup>26</sup>

Some commenters suggested that any expanded disclosure requirements should come from the SEC and the Financial Accounting Standards Board ("FASB"), in the form of additional

management disclosures, rather than from the Board expanding requirements for auditor reporting. However, investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for the investor's benefit. As one commenter noted, the auditor is best suited to provide insights on how and on what basis the auditor developed its opinion. The final standard is designed to elicit information about the audit directly from the auditor's perspective.

If auditors can adequately convey to investors the principal considerations and how the auditor addressed the matter without including previously undisclosed information, it is expected that they will. However, the standard provides that even when management has not disclosed information, the auditor is not constrained from providing such information if it 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 Board intends to monitor implementation of the critical audit matter requirements to determine if additional guidance is needed in this area.

#### Potential Compliance Issues Related to Critical Audit Matters

Some commenters suggested that the reporting of critical audit matters could create compliance challenges for companies.

Two commenters expressed concern that companies' SEC filings may have to be amended because of changes in the description or reporting of critical audit matters. In principle, auditors should approach errors and misstatements in the communication of critical audit matters in the same way they would approach any other error or misstatement in the auditor's report that does not affect the auditor's opinion or the ability of market participants to rely on the opinion.<sup>27</sup> It appears that under current practice, SEC filings have been amended solely to correct errors in auditor's reports, such as incorrect auditor's report dates or missing explanatory paragraphs.

Another commenter expressed concern that management may be asked to respond to investor questions regarding issues described in critical audit matters and may not be in a

position to do so, particularly in light of their responsibilities under Regulation FD. Given the auditor's responsibility to communicate with the audit committee, and the likelihood of extensive discussions between auditors and management regarding critical audit matters, it seems likely that management will be prepared to respond appropriately and in compliance with their legal obligations (including Regulation FD), as they would with regard to any other question about information included in an SEC filing.

#### Ability To Communicate No Critical Audit Matters

The reproposal provided that the auditor could determine there were no critical audit matters and provide a statement to that effect in the auditor's report. Commenters generally supported the auditor's ability to determine that there are no critical audit matters. Two commenters suggested that the auditor should not have to make a statement in the auditor's report that there were no critical audit matters because the absence of a critical audit matter should be sufficient without the definitive statement, similar to an emphasis paragraph. The final standard includes the possibility that the auditor could determine, and state in the auditor's report, that there are no critical audit matters.<sup>28</sup> The statement that there are no critical audit matters is required because unlike an emphasis paragraph, critical audit matters are a required element of the auditor's report.

The determination of critical audit matters is based on the facts and circumstances of each audit. The Board expects that, in most audits to which the requirement to communicate critical audit matters applies, the auditor will determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. There may be critical audit matters even in an audit of a company with limited operations or activities. However, there may be circumstances in which the auditor determines there are no matters that meet the definition of a critical audit matter and, in those circumstances, the auditor will communicate that there were no critical audit matters.

<sup>28</sup> Since communication of critical audit matters will not be required for the audits of EGCs, brokers and dealers reporting under Exchange Act Rule 17a-5, 17 CFR 240.17a-5, investment companies other than business development companies, and benefit plans, the auditor's report for the audits of these entities will not be required to include the statement that there are no critical audit matters.

<sup>25</sup> See AS 1301.21, as amended.

<sup>26</sup> It should be noted that the determination that a matter was a significant deficiency in internal control over financial reporting, on its own, could not be a critical audit matter.

<sup>27</sup> The final standard indicates that the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole.

### Requirements of Other Regulators and Standard Setters

*IAASB.* For each key audit matter, the IAASB requires the auditor to reference the related disclosures, if any, in the financial statements and address: (1) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter and (2) how the matter was addressed in the audit.<sup>29</sup> The IAASB allows the auditor to determine that there are no key audit matters to communicate in the auditor's report and, if so, requires a statement to this effect.<sup>30</sup>

*EU.* The EU requires the auditor to include in the auditor's report: (1) A description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud; (2) a summary of the auditor's response to the risks; and (3) where relevant, key observations arising with respect to the risks.<sup>31</sup>

*FRC.* The FRC requires the auditor, among other things, to: (1) Describe those assessed risks of material misstatement that were identified by the auditor and (2) provide an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement.<sup>32</sup> The explanations of the matters set out in the auditor's report should be described in a way that: (1) Enables a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements; (2) enables the matters to be related directly to the specific circumstances of the audited entity and are not therefore generic or abstract matters expressed in standardized language; and (3) complements the description of significant issues required to be made by the audit committee.<sup>33</sup>

### Documentation of Critical Audit Matters

The repropoed standard required documentation of the basis for the auditor's determination whether each matter that both: (1) Was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved or did not involve especially challenging, subjective, or complex auditor

judgment. Some commenters supported a documentation requirement only for matters that were determined to be critical audit matters. Some of these commenters asserted that documentation about matters determined not to be critical audit matters would add costs and primarily benefit PCAOB inspections rather than audit quality. Others stated that the requirement is not aligned with the IAASB's documentation requirement, which, in their view, focuses on rationale for inclusion as a key audit matter rather than exclusion. However, another commenter argued that the determination that a matter was not a critical audit matter would seem to be an important audit judgment that ought to be documented for review by the engagement quality reviewer. This commenter suggested that documentation be required only for matters required to be communicated to the audit committee (which would already have been documented) and not for those that are communicated otherwise. One auditor argued that the repropoed requirement would lead auditors to document all audit committee communications even if not required, and that this would disproportionately affect smaller companies whose audit committees more commonly request information not required to be communicated under PCAOB standards.

The final standard substantially retains the approach from the repropoal of requiring the auditor to document the basis for determining critical audit matters.<sup>34</sup> The objective of the requirement is to document how the determination of critical audit matters (or the determination that there are no critical audit matters) was made from among the matters communicated or required to be communicated to the audit committee that relate to accounts or disclosures that are material to the financial statements. The documentation requirement will also facilitate review by the engagement quality reviewer.<sup>35</sup>

The amount of documentation required could vary with the circumstances. For example, the auditor's basis for the determination

may be so clear for some matters that a single sentence will be sufficient. This situation may arise, for instance, when the auditor's documentation prepared in the course of the audit includes sufficient detail about whether or not the matter involved especially challenging, subjective, or complex auditor judgment. Other matters may require more extensive documentation.

As noted in the repropoing release, for matters determined to be critical audit matters, the description in the auditor's report (which, among other things, must describe the principal considerations that led the auditor to determine that it was a critical audit matter) will generally suffice as documentation.

The auditor could comply with the documentation requirement in a variety of different ways. For example, the auditor could start with the communications to the audit committee, which are already documented, identify which of those matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether or not each matter involved especially challenging, subjective, or complex auditor judgment. In documenting the basis for the determination, the auditor may include the factors the auditor took into account. This documentation may be prepared as an extension to the audit committee documentation or the auditor may prepare separate documentation.

### Requirements of Other Regulators and Standard Setters

The IAASB requires the auditor to document the matters that required significant auditor attention and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter.<sup>36</sup> The EU does not include documentation requirements for expanded auditor reporting. The FRC does not include specific documentation requirements related to expanded auditor reporting.<sup>37</sup>

### Liability Considerations Related to Critical Audit Matters

In both the proposal and the repropoal, the Board acknowledged that including critical audit matters would change the auditor's report in ways that could affect auditors' potential liability. As discussed in those releases, liability may be imposed on auditors under a number of different legal theories depending on the specific

<sup>34</sup> The language of the documentation requirements has been redrafted to improve clarity, based on a commenter's suggestion.

<sup>35</sup> Under the existing audit documentation requirements, audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. See paragraph .02 of AS 1215, *Audit Documentation*.

<sup>36</sup> See paragraph 18(a) of ISA 701.

<sup>37</sup> General documentation requirements appear in ISA (UK and Ireland) 230, *Audit Documentation*.

<sup>29</sup> See paragraph 13 of ISA 701.

<sup>30</sup> See paragraphs 14 and 16 of ISA 701.

<sup>31</sup> See requirements in 2(c) of Article 10, Audit Report, of Regulation (EU) No. 537/2014.

<sup>32</sup> See paragraph 19A of UK ISA 700 (2013).

<sup>33</sup> See paragraph 19B of UK ISA 700 (2013).

facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, and various state law causes of action. The critical audit matters would themselves be new statements that could be the basis for asserted claims. In addition, information provided regarding critical audit matters could affect other aspects of securities fraud claims against either the issuer, the auditor, or both (for example, by being described in pleadings in an effort to plead fraud with particularity or as a basis to seek to undercut a claim of reliance). The Board specifically sought comment on what effect the communication of critical audit matters would have on private liability and whether there were any steps the Board could or should take to address any likelihood of an increase in potential liability in private litigation.

A number of companies and accountants responded to this request for comment. While several of these commenters noted that changes from the proposal had addressed certain of their liability concerns, most continued to express varying degrees of concern about the potential for increased liability, either for auditors or for both auditors and companies.

In particular, commenters expressed concern that investors who suffer a financial loss could assert legal claims against the auditor based on statements made in identifying and describing critical audit matters. As with the proposal, commenters expressed general concerns that communication of critical audit matters would encourage baseless litigation, would likely lead to increased audit fees, raise the settlement value of spurious claims, or potentially undermine the stringent pleading standards of the Private Securities Litigation Reform Act of 1995, which were intended to curtail non-meritorious claims against auditors and avoid the costs and burdens associated with them. Some commenters argued that auditors, to avoid being second-guessed, would have the incentive to communicate matters to the audit committee that were not otherwise required or to identify too many critical audit matters in an effort to protect themselves from liability. Several commenters expressed concern that communicating critical audit matters might compromise their ability to argue that the statements in the audit report are opinions which, one commenter argued, were “less vulnerable to challenges that they are false or

misleading.”<sup>38</sup> However, at least one of these commenters noted that the revised definition of a critical audit matter in the reproposal mitigated their concern on that point. Other commenters argued that the information communicated in describing critical audit matters could potentially be used to attack the audit by challenging the procedures performed or the adequacy of audit evidence obtained by the auditor. On the other hand, one commenter noted that the communication of critical audit matters is about disclosure of risks and challenges and expressed the belief that non-communication of such matters would be more problematic from a litigation point of view.

Some commenters argued that the risk of liability would be heightened if the auditor were providing original information about the company. In particular, several commenters contended that doing so would conflict with accountants’ professional obligation to maintain client information in confidence, which could give rise to claims by the company against the auditor under state law.

Some commenters argued that critical audit matters could increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, could be misinterpreted as acts of negligence on the part of the company, or could be used by plaintiffs as a “road map” for litigation against the company. One commenter argued that, because the underlying work papers are subject to discovery, critical audit matters would be used as a source for potential litigation against both auditors and companies.

Some of the commenters that expressed concerns about the potential for increased auditor liability also suggested changes to the reproposal that they maintained would reduce the liability impact of determining and communicating critical audit matters. For example, as previously discussed, several commenters suggested substantially similar changes to modify the materiality component of the definition of critical audit matters and to prohibit or discourage auditor communication of original information.

The Board has carefully considered commenters’ concerns about potential liability throughout this standard-setting process, including the comments received on the reproposal. While mandating disclosure of critical audit matters will, by design, entail new

statements in the auditor’s report, the Board notes that any claim based on these new statements would have to establish all of the elements of the relevant cause of action (for example, when applicable, loss causation and reliance). Critical audit matters will not replace or alter the fundamental requirement that the auditor’s report include the auditor’s opinion that the financial statements are fairly presented in accordance with the applicable financial reporting framework, which has been, and the Board expects will continue to be, the primary statement at issue in most private securities litigation under federal law involving auditors.

Throughout this standard-setting process, the Board has carefully considered commenters’ suggestions to alter the terms of its proposal to mitigate their concerns about potential liability for omitting a critical audit matter. As discussed in the reproposal, the Board limited and clarified the process for determining critical audit matters, including by narrowing the source of critical audit matters to matters communicated or required to be communicated to the audit committee, adding a materiality component to the critical audit matter definition, and refining the factors used to determine critical audit matters. Those changes, as well as the critical audit matter definition’s focus on the auditor’s judgment, should mitigate concerns about potential liability for omitting a critical audit matter. With respect to suggestions to further narrow the definition of critical audit matters and the related communication requirements, it is not clear, and commenters did not explain, how those changes would mitigate liability concerns other than by reducing the number and content of required communications of critical audit matters. As described above, the Board has determined not to incorporate those suggested changes because they appear likely to significantly reduce the number of potential critical audit matters and the informativeness of auditor communication of critical audit matters.

With respect to potential state law claims by companies against their auditors for disclosing original information, the Board notes that, as discussed above, it does not expect that, in general, critical audit matters will provide sensitive information that has not been disclosed by the company. With respect to the potential for a claim based on a situation in which the auditor found such disclosure necessary, the Board notes that auditors already have preexisting duties to

<sup>38</sup> Letter from PricewaterhouseCoopers LLP (Aug. 15, 2016) at 7, available on the Board’s Web site in Docket 034.

disclose original information in certain circumstances.<sup>39</sup> Commenters did not cite any specific examples in which these requirements have resulted in unwarranted claims against auditors for disclosing client confidences. Because the auditor's obligations under PCAOB standards arise under federal law and regulations, professional or state law duties of client confidentiality should not apply to,<sup>40</sup> or should be preempted by,<sup>41</sup> the obligation to communicate critical audit matters.<sup>42</sup>

While the Board takes seriously the prospect of potential increases in auditors' or companies' liability, the Board believes it has appropriately addressed commenters' concerns regarding liability in a manner compatible with the objectives of this rulemaking, and in view of the rulemaking's anticipated benefits. Indeed, the Board notes that at least one of the commenters that expressed concern about potential liability, noted that those concerns "should not stand in the way of moving forward" on the repropoed standard.<sup>43</sup> At the same time, the Board acknowledges that a

<sup>39</sup> For example, for at least the last 20 years, auditors have had duties to disclose in their auditor's reports when they have substantial doubt about the company's ability to continue as a going concern. See Section 10A of the Exchange Act and AS 2415. In addition, when in an audit of internal control over financial reporting, the auditor identifies a material weakness that has not been included in management's assessment, the auditor must modify its report to, among other things, "include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements . . .". See Note to paragraph .91 of AS 2201; cf. Statement of Gaylen R. Hansen, CPA, at the PCAOB public meeting (Apr. 2, 2014) ("Client confidentiality has a long-standing and important place in the accountancy profession. However, it doesn't serve investors well when it is parlayed to obfuscate the important obligation to call things as they are seen.").

<sup>40</sup> For example, the relevant AICPA rule provides that auditors "shall not disclose any confidential client information without the specific consent of the client," but further provides that the confidentiality obligation shall not be construed "to prohibit . . . compliance with applicable laws and government regulations." See paragraphs .01 and .02 of 1.700.001 *Confidential Client Information Rule* of the AICPA Code of Professional Conduct (as of Dec. 15, 2014).

<sup>41</sup> See *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372–73 (2000); *New York v. FCC*, 486 U.S. 57, 64 (1988).

<sup>42</sup> Some commenters suggested that safe harbor rules be created to protect auditors and companies from liability for statements about critical audit matters. While, as noted above, the Board will monitor the effects of critical audit matters should the requirements be approved by the SEC, the Board is not convinced at this time that any such safe harbor is necessary and, in any event, such a safe harbor is beyond the Board's authority.

<sup>43</sup> See letter from Deloitte & Touche LLP (Aug. 12, 2016) at 5, available on the Board's Web site in Docket 034.

variety of claims can be raised related to the statements in the audit report and that litigation is inherently uncertain. If the final standard is approved by the SEC, the Board will monitor the standard after implementation for any unintended consequences.

#### Additional Improvements to the Auditor's Report

The reproposal provided a list of basic elements to be included in every auditor's report. Some of these basic elements, such as auditor tenure, would be new elements in the auditor's report. Other basic elements, such as the auditor's opinion, identification of the financial statements audited, and management's and auditor's responsibilities, were drawn from the existing auditor reporting standard.<sup>44</sup> Yet other basic elements, such as the name of the company under audit and the date of the financial statements, were incorporated from existing illustrative auditor's reports.

#### Auditor Tenure

The reproposal included a required statement in the auditor's report of the year the auditor began serving consecutively as the company's auditor. The Board also sought comment on whether auditor tenure should be disclosed in Form AP, *Auditor Reporting of Certain Audit Participants* ("Form AP"), rather than in the auditor's report.<sup>45</sup>

#### Disclosure of Tenure

Investor commenters stated that information regarding auditor tenure would be useful to financial statement users, for example, in deciding whether to vote to ratify the appointment of the auditor. Investors that expressed a preference supported tenure disclosure in the auditor's report, some on the basis of reducing investor search costs by ensuring a consistent location for the disclosure. One commenter representing a group of investors asserted that since the auditor's report is the primary means by which the auditor communicates with investors, it is appropriate for auditor tenure to be included in the auditor's report. This commenter further stated that disclosure of auditor tenure on Form AP would be

<sup>44</sup> See existing AS 3101.06–.08.

<sup>45</sup> In December 2015, the Board adopted Form AP, which provides investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. See *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015–008 (Dec. 15, 2015).

an acceptable alternative to disclosure in the auditor's report only if the timeliness, accessibility, searchability, and overall functionality of the information disclosed on Form AP were at least equivalent to having the information disclosed in the auditor's report. Another commenter suggested that, if disclosure were required in the auditor's report, a specific location should be designated.

Currently, information about auditor tenure is not required to be communicated to investors by the auditor, management, or the audit committee.<sup>46</sup> However, there is a growing trend toward voluntary disclosure of auditor tenure. Recent analysis of corporate proxy statements for annual meetings of shareholders has found that a growing number of companies are disclosing auditor tenure,<sup>47</sup> presumably due to interest from investors. However, voluntary disclosure is not provided for a significant number of audits subject to the Board's jurisdiction. Additionally, if disclosed, such information may not be provided in the same location in the proxy statement; for instance, some disclosures are in the audit committee report while others are in another section of the proxy.<sup>48</sup> Further, the proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, many companies whose

<sup>46</sup> In certain instances, investors may be able to manually calculate tenure by reviewing company filings on the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") to determine when a company changed auditors. However, the information is not available prior to 1994 and may not be available for certain entities, such as investment companies and brokers and dealers, that are not required to file Form 8–K. See 17 CFR 249.308, Item 4.01 *Changes in Registrant's Certifying Accountant*. Accordingly, currently available information is neither complete nor a readily accessible alternative to auditor tenure disclosure.

<sup>47</sup> The Center for Audit Quality, together with Audit Analytics, reviewed corporate proxies filed through the end of June 2016, 2015, and 2014 of 1,500 Standard and Poor's ("S&P") Composite companies. Their analysis identified that in 2016, 2015, and 2014 auditor tenure was disclosed in the annual proxy statements of 59, 54, and 47 percent of the S&P 500 large-cap companies, respectively, 45, 44, and 42 percent of the S&P MidCap 400 companies, respectively, and 48, 46, and 50 percent of the S&P SmallCap 600 companies, respectively. See Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016). Separately, during their review of proxy statements of Fortune 100 companies, Ernst & Young identified that 63 percent of the companies reviewed voluntarily disclosed auditor tenure in 2016 compared to 62 percent in 2015, 51 percent in 2014, 29 percent in 2013, and 24 percent in 2012. See Ernst & Young, *Audit Committee Reporting to Shareholders in 2016* (Sept. 2016).

<sup>48</sup> See Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016).

securities are not listed on a national securities exchange, and most investment companies are not required to prepare proxy statements.

Some commenters, primarily companies, did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors. Other companies and accounting firms raised a concern that tenure disclosure could result in inferences that, in their view, would be inappropriate about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. Some commenters also suggested that auditor tenure is a corporate governance matter and that disclosure should be provided by management or the audit committee rather than the auditor. A few commenters suggested that tenure disclosure should be addressed by SEC rulemaking or provided only voluntarily. Some commenters, many of whom generally opposed auditor tenure disclosure, suggested that Form AP would be a preferable location for disclosing tenure if the Board proceeded with requiring the disclosure.

The SEC's Investor Advocate stated that he "strongly support[s] requirements for public disclosure of auditor tenure," recognizing that there were different opinions about the best party and location to make that disclosure.<sup>49</sup> Noting that the SEC had issued a concept release asking whether auditor tenure should be disclosed in the audit committee report,<sup>50</sup> the SEC's Investor Advocate stated that he believed the SEC should ultimately decide these questions. In light of these considerations, the SEC's Investor Advocate recommended that the PCAOB act to require disclosure of auditor tenure (either in the auditor's report or in Form AP), but also consider including a contingent sunset clause such that the auditor disclosure requirement would expire if and when the SEC imposed any form of a company disclosure requirement.

The Board believes that public disclosure of auditor tenure is important and in the public interest, and that it is

appropriate to require disclosure in the auditor's report because it is the primary means by which auditors communicate with investors. This will ensure that the disclosure is in a readily accessible and consistent location—the auditor's report—for all companies. It will make auditor tenure information immediately available to investors upon filing with the SEC of a document containing the auditor's report. Disclosure of auditor tenure in the auditor's report will also reduce search costs for investors who are interested in auditor tenure, relative to the current environment of voluntary reporting. Disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The Board is not persuaded by commenters' concerns that disclosure of auditor tenure in the auditor's report necessarily suggests a specific correlation between auditor tenure and audit quality, or between auditor tenure and auditor independence. In the Board's view, auditor tenure is another data point about the auditor, in addition to the firm name and the office issuing the auditor's report, for which there is demonstrable investor demand.

The standard does not specify a required location within the auditor's report for the statement on auditor tenure; auditors that are concerned about the inferences readers may draw based on the placement of the disclosure in the auditor's report have discretion to present auditor tenure in the part of the auditor's report they consider appropriate. Consistent with the reproposal, the illustrative auditor's report in the final standard includes the statement on auditor tenure at the end of the report.

The Board considered disclosure of auditor tenure in Form AP, which requires disclosure of the name of the engagement partner and of the names and percentage of participation of other accounting firms in the audit for all issuer audits. Form AP was developed primarily to respond to commenter concerns about the potential liability consequences of naming persons in the auditor's report, the potential need to obtain consents from those named persons in connection with registered securities offerings, and the additional time needed to compile information about the other accounting firms. The Board's determination to require disclosure in Form AP, rather than in the auditor's report, was a means to address these concerns. Disclosure of auditor tenure does not have the same potential liability or other consequences

as disclosure of the name of the engagement partner or other accounting firms, so such an approach is unnecessary in this case.

The Board acknowledges that the SEC, given its broader authority and responsibility for the financial reporting process, could in the future determine that auditor tenure should be disclosed by some other party or in some other location, in addition to or instead of in the auditor's report. Accordingly, the Board is adopting its requirement for tenure disclosure in the auditor's report today. The Board anticipates that, if the SEC undertook rulemaking for disclosure of auditor tenure, the Board would work with the SEC to ensure that PCAOB standards coordinate appropriately with any new SEC requirements.<sup>51</sup>

#### Determination of Tenure

The reproposal contemplated that tenure would be calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure, and it included a note providing that if the auditor is uncertain as to the year the auditor became the company's auditor, the auditor should so state and provide the earliest year of which the auditor has knowledge. Some commenters objected to this approach, saying that it could confuse investors and its relevance is unclear. The Board believes that the disclosure of tenure should reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit. No changes have been made to the note in the final standard.

Additionally, if a company went public and maintained the same auditor, auditor tenure will include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Because of the unique structure of investment companies, which typically includes common accounting, internal control, and oversight functions at the group level, the reproposed standard required that, for an investment company that is part of a group of investment companies,<sup>52</sup> the auditor's

<sup>51</sup> Of course, the SEC also has authority to abrogate or modify PCAOB rules at any time, to, among other things, further the purposes of the securities laws. Section 107(b)(5) of Sarbanes-Oxley, 15 U.S.C. 7217(b)(5).

<sup>52</sup> A group of investment companies, as defined by Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"), means any two or more registered investment companies that hold themselves out to investors as

<sup>49</sup> See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 4, available on the Board's Web site in Docket 034. The letter noted that the views of the Investor Advocate do not necessarily reflect the views of the SEC, the Commissioners, or staff of the SEC, and the SEC disclaims responsibility for the letter and all analyses, findings, and conclusions contained therein. Additional information about the Office of the Investor Advocate is available on the SEC's Web site.

<sup>50</sup> See SEC, *Possible Revisions to Audit Committee Disclosures*, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015).

statement regarding tenure will contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies.<sup>53</sup> For example, if Firm A has been auditing investment companies in XYZ group of investment companies since 1980, the current auditor's report for XYZ fixed income fund, whose inception date was in 2010, will state that Firm A has served as the auditor of one or more XYZ investment companies since 1980.

A commenter asserted that measuring auditor tenure from the first year of service to the group of investment companies might confuse or even mislead the reader of the auditor's report for a new fund, especially if the auditor has served the group for several years. Another commenter supported the repropoed methodology for measuring tenure for investment companies stating that it is appropriate given the common accounting system, system of internal control over financial reporting, and board oversight for a group of investment companies.

After considering the comments received, the Board is adopting the requirement regarding auditor tenure for an investment company that is part of a group of investment companies as repropoed. The Board believes that the length of an auditor's relationship with the group is more relevant than the relationship with an individual fund, since funds can be started and merged over time but the auditor's relationship with the group continues.

#### Requirements of Other Regulators and Standard Setters

The EU requires a statement in the auditor's report that indicates the total uninterrupted engagement period, including previous renewals and reappointments of the statutory auditors or the audit firms.<sup>54</sup> The IAASB and the FRC do not include a similar requirement.

#### Clarification of Existing Auditor's Responsibilities

The repropoed standard included requirements that would enhance standardized language of the auditor's report by clarifying the nature and scope of the auditor's existing responsibilities,

related companies for purposes of investment and investor services. For purposes of determining auditor tenure, any tenure with other entities that may be part of an investment company complex, such as investment advisers or private investment companies, is not included.

<sup>53</sup> The following is an example of such statement: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

<sup>54</sup> See requirements in 2(b) of Article 10, Audit Report, of Regulation (EU) No 537/2014.

such as a new statement regarding auditor independence and the addition of 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. In addition, the repropoed standard included a requirement intended to promote uniformity with respect to the addressee of the report.

#### Auditor Independence

The repropoed standard included a required statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC<sup>55</sup> and the PCAOB.<sup>56</sup>

Commenters generally supported the required statement regarding auditor independence. Some said that the statement would reinforce financial statement users' understanding of the auditor's existing obligations to be independent and serve as a reminder to auditors of these obligations. Some commenters preferred a more definitive statement, such as stating that the auditor is in fact independent and in compliance with applicable independence rules. A few commenters questioned whether the statement will improve an investors' understanding of the auditor's independence responsibilities, yield any incremental benefits or insight to investors, or have any impact on auditor behavior. Some of these commenters pointed out that independence is already included in the title of the auditor's report and including an additional statement in the auditor's report is redundant and unnecessary.

After consideration of comments, the statement regarding auditor independence is adopted as repropoed. The Board believes that the independence statement in the auditor's report will both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations. The statement regarding auditor independence is not intended to, and will not, affect auditor independence requirements under the securities laws, SEC rules, or PCAOB rules.

<sup>55</sup> See Regulation S-X Rule 2-01, 17 CFR 210.2-01.

<sup>56</sup> See PCAOB Rule 3520, *et seq.*

#### Requirements of Other Regulators and Standard Setters

The IAASB requires that the auditor's report include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.<sup>57</sup> The EU requires a statement in the auditor's report that the auditor remained independent of the audited entity in conducting the audit.<sup>58</sup> The FRC requires the auditor to state that the auditor is required to comply with the United Kingdom's ethical standards for auditors, which include requirements regarding auditor independence.<sup>59</sup>

#### Addressee

Under the existing standard, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.<sup>60</sup> Under current practice, the auditor's report is generally addressed to one or more of the following: (1) The board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.<sup>61</sup>

To promote consistency in addressing the auditor's report to the company's investors, the repropoed standard included a requirement for the auditor's report to be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The repropoed standard stated that the auditor's report may include additional addressees.

Commenters generally supported the addressee requirement as repropoed stating that it is appropriate and will create consistency in practice. A commenter suggested limiting the required addressees to the shareowners of corporations or equivalents for companies not organized as corporations because investors are the key customers of the auditor's report. A few commenters stated that the auditor's report is intended for general use and the requirement for the auditor's report to be addressed to a specific party is not

<sup>57</sup> See paragraph 28(c) of ISA 700.

<sup>58</sup> See requirements in 2(f) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

<sup>59</sup> See paragraph 15 of UK ISA 700 (2013).

<sup>60</sup> See existing AS 3101.09.

<sup>61</sup> This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers and brokers and dealers.



necessary. A commenter expressed concern that retaining the option for the auditor's report to be addressed to third parties could inadvertently result in increased auditor liability and cost.

In response to comments, and to promote greater uniformity in the addressees of the auditor's report, the Board is adopting the addressee requirement as repropoed. Since inclusion of additional addressees is voluntary, auditors could assess, based on the individual circumstances, whether or not to include additional addressees in the auditor's report. In addition, the Board believes that it is appropriate for the auditor's report to be addressed to the board of directors and not just to the shareholders, because of the role of the board of directors in the governance of the company.

#### Requirements of Other Regulators and Standard Setters

The IAASB requires that the auditor's report be addressed as appropriate, based on the circumstances of the engagement.<sup>62</sup> The EU does not specify the addressee of the auditor's report. The FRC requires that the auditor's report be addressed as required by the circumstances of the engagement.<sup>63</sup> UK auditor's reports are typically addressed to either the members or the shareholders of the company.<sup>64</sup>

#### Other Enhancements to the Basic Elements

The reproposal would have changed the language for certain elements in the existing auditor's report. These elements included:

- *Financial statement notes*—The identification of the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.<sup>65</sup> Under the existing standard, the notes to the financial statements and the related schedules are not identified as part of the financial statements.

<sup>62</sup> See paragraph 22 of ISA 700.

<sup>63</sup> See paragraph 13 of UK ISA 700 (2013).

<sup>64</sup> See paragraph A5 of UK ISA 700 (2013).

<sup>65</sup> The final standard uses the term "financial statements" to include all notes to the statements and all related schedules, as used under SEC rules that apply to issuers. See Regulation S-X Section 1-01(b), 17 CFR 210.1-01(b), which states in part, "the term financial statements . . . shall be deemed to include all notes to the statements and all related schedules." The final standard will not apply to schedules included as supplemental information, as defined in AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, because those schedules are not considered part of the financial statements. The auditor should continue to look to the requirements of AS 2701 for the auditor's reporting responsibilities regarding supplemental information accompanying audited financial statements.

- *Error or fraud*—A description of the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.<sup>66</sup> The existing standard does not require the auditor's report to contain the phrase *whether due to error or fraud*.

- *Nature of the audit*—The description of the nature of the audit reflected the auditor's responsibilities in a risk-based audit and aligned the description with the language in the Board's risk assessment standards, including:

- Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
- Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;

- Evaluating the accounting principles used and significant estimates made by management; and
- Evaluating the overall presentation of the financial statements.

Commenters generally supported the repropoed language for these basic elements of the auditor's report. These elements are adopted as repropoed.

#### Additional Basic Elements Suggested by Commenters

In addition to the changes proposed by the Board, commenters on the reproposal suggested additional elements to be included in the auditor's report.

Several commenters suggested that the PCAOB consider additional standardized language in the auditor's report to describe the responsibilities of the auditor, management, and the audit committee. In doing so, some of these commenters suggested that the PCAOB consider additional language adopted by the IAASB, in order to promote consistency in reporting and to help users understand more fully the separate responsibilities of each of the parties with respect to the audited financial statements. In contrast, another commenter cautioned that a thorough description of everyone's roles and responsibilities would further add to repetitive boilerplate language. This commenter suggested instead that the auditor's report provide a cross reference to a more complete description of the roles and responsibilities of the auditor,

<sup>66</sup> See paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

management, and the audit committee. This commenter did not indicate where such cross-referenced material would appear. Given little interest from investors in such additional language during the Board's initial outreach and the risk that it would be boilerplate, the final standard does not include these additional elements.

Two accounting firms suggested describing the meaning of reasonable assurance. The final standard requires a statement in the "Basis for Opinion" section of the auditor's report that the auditor "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The auditing standards describe reasonable assurance as a high level of assurance, although not absolute assurance.<sup>67</sup> During the Board's initial outreach such additional language was considered, but there was no investor demand for it. As a result, the final standard does not expand the description of reasonable assurance in the auditor's report.

Some commenters also suggested that the auditor's report should include disclosure of the materiality measures used by auditors in planning the audit. These commenters asserted that it could help inform investors' proxy voting process for auditor ratification, as such disclosure could be a valuable supplement to an audit fee analysis and used to compare materiality over time to trends in restatements and adjustments. These commenters also observed that materiality disclosures are provided in the auditor's reports in the U.K. Other commenters from the Board's initial outreach stated that disclosing materiality levels in the auditor's report could have negative implications on audit quality by reducing the element of surprise necessary in an audit.<sup>68</sup> One commenter opposed a disclosure of materiality on the basis that it may encourage disclosure of quantitative materiality levels and ignore qualitative aspects of materiality, which cannot be described in a meaningful way in the auditor's report. The Board has decided not to include this additional element in the auditor's report at this time because disclosure may reduce the element of surprise in the audit and overstate the importance of quantitative rather than qualitative factors in the auditor's overall consideration of materiality. However, the Board will monitor the implementation of the final standard, as

<sup>67</sup> Paragraph .10 of AS 1015, *Due Professional Care in the Performance of Work*.

<sup>68</sup> See PCAOB Release No. 2011-003, Appendix C, for a detailed discussion of the staff's outreach regarding reporting materiality levels.

well as the developments of expanded auditor reporting in other jurisdictions, to determine if future enhancements to the auditor's report may be warranted in this area.

Additionally, some commenters suggested that the auditor's report should define the auditor's responsibility for other information in documents containing audited financial statements so that financial statement users have a clear understanding. The Board's proposal included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements. The Board has not taken any further action since the proposal.

A few commenters suggested including other elements, such as the date when the auditor completed fieldwork, a statement that the auditor looked for material fraud, disclosure when alternative dispute resolution clauses are included in engagement letters, and disclosure of reasons for change in the engagement partner prior to mandatory rotation. The final standard does not include these elements because the Board believes they would not add meaningfully to the information already provided in the final standard or the elements go beyond what was considered in this standard-setting project and, thus, the Board is not including these elements at this time.

#### Explanatory Language and Emphasis of a Matter

##### Explanatory Language Required by Other PCAOB Standards

The repropoed standard, similar to the existing standard,<sup>69</sup> provided a list of circumstances in which the auditor is required to add explanatory language to the auditor's report and included references to other PCAOB standards in which these circumstances and related reporting requirements are described. These circumstances included when there is substantial doubt about the company's ability to continue as a going concern and a restatement of previously issued financial statements, among others.

The list of circumstances from the Board's reproposal did not attract much comment, although one commenter affirmed support for including the list. Commenters on the Board's proposal

supported providing a list in the standard of the circumstances that require explanatory language in the auditor's report on the basis that keeping this information in a single place would facilitate consistency in execution. The final standard includes the list of explanatory paragraphs and related references as repropoed.

The repropoed standard included a requirement for the auditor to add explanatory language in cases where the company is required to report on ICFR but has determined that it is not required to obtain, and did not request the auditor to perform, an audit of ICFR.<sup>70</sup> The repropoed standard included a reference to a new proposed requirement in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the auditor to add such explanatory language. Some commenters were supportive of the repropoed requirement, while one commenter did not believe such a requirement was necessary but did not object to its inclusion.

The Board also sought comment on whether the requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR should apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies. Several commenters supported expanding the requirement to all instances in which the auditor is not engaged to opine on ICFR, and not limit it to only when management is required to report on ICFR.

In the Board's view, it is appropriate to add explanatory language to the auditor's report when management has a reporting responsibility on ICFR but the auditor is not engaged to opine on ICFR, in order to clarify the auditor's responsibilities in this situation. For companies for which management is not required to report on ICFR, the Board does not believe that the auditor should have a separate reporting responsibility. Accordingly, the final standard retains the requirement as repropoed.<sup>71</sup> The auditor may, however, choose to

<sup>69</sup> This may be the case for companies that are subject to Section 404(a) of Sarbanes-Oxley, which mandates management ICFR reporting, but not Section 404(b), which mandates auditor ICFR reporting. Section 404(a) generally applies to companies that are subject to the reporting requirements of the Exchange Act, other than registered investment companies. Certain categories of companies that are subject to Section 404(a), such as nonaccelerated filers and emerging growth companies, are not subject to Section 404(b).

<sup>71</sup> See amendments to AS 3105.59–60.

include such a paragraph in the auditor's report voluntarily.

*Interaction between critical audit matters and explanatory paragraphs.* The repropoed standard clarified that critical audit matters are not a substitute for required explanatory paragraphs. However, there could be situations in which a matter meets the definition of a critical audit matter and also requires an explanatory paragraph, such as going concern. For these situations, the repropoed standard contemplated that both the explanatory paragraph and the required communication regarding the critical audit matter would be provided. The auditor could include the communication required for a critical audit matter in the explanatory paragraph, with a cross-reference in the critical audit matter section to the explanatory paragraph. Alternatively, the auditor could choose to provide both an explanatory paragraph and the critical audit matter communication separately in the auditor's report, with a cross-reference between the two sections.<sup>72</sup> While the information reported in a critical audit matter may overlap with some of the information already provided in the explanatory paragraph, the critical audit matter would provide incremental information, such as how the matter was addressed in the audit.

Commenters were generally supportive of the interaction between the communication of critical audit matters and required explanatory paragraphs as described in the repropoed standard. Some alternative views, however, were expressed. One commenter thought that if a required explanatory paragraph is also a critical audit matter, disclosure in the auditor's report should be limited to one place in the auditor's report. The commenter suggested that the communication requirements for both a critical audit matter and an explanatory paragraph be reported in the critical audit matter section of the auditor's report with a cross reference in the explanatory paragraph section. Another commenter suggested that the PCAOB harmonize its approach with that of the IAASB, which requires a reference in the key audit matter section but waives the requirements to describe the key audit matter and how it was addressed during the audit. Finally, another commenter thought that critical audit matter communications should not be

<sup>72</sup> When both an explanatory paragraph and a critical audit matter communication are provided, the critical audit matter description should not include conditional language that would not be permissible in the explanatory paragraph. See footnote 5 of AS 2415.

<sup>69</sup> See existing AS 3101.11.

permitted to be integrated with explanatory paragraphs, on the basis that explanatory paragraphs are about matters in the financial statements to which the auditor wants to draw the reader's attention and are not necessarily critical audit matters.

The final standard retains the interaction between critical audit matters and explanatory paragraphs as repropoed. The approach provides flexibility on auditor disclosure, yet also ensures that the communication requirements are met.

#### Emphasis of a Matter

The repropoed standard, similar to the existing standard, provided the ability for the auditor to add a paragraph to the auditor's report to emphasize a matter regarding the financial statements ("emphasis paragraph").<sup>73</sup> Emphasis paragraphs are not required, but may be used by auditors to draw the reader's attention to matters such as significant transactions with related parties and unusually important subsequent events.

The repropoed standard provided a list of potential matters that the auditor may emphasize in the auditor's report, although the auditor may also decide to emphasize other matters.

Commenters were supportive of emphasis paragraphs as described in the repropoed standard and did not suggest any additional matters to be included in the list of potential emphasis paragraphs. The final standard includes emphasis paragraphs as repropoed.

*Interaction between critical audit matters and emphasis paragraphs.* The repropoed standard stated that emphasis paragraphs are not a substitute for required critical audit matters. If a matter that the auditor considers emphasizing meets the definition of a critical audit matter, the auditor would provide the information required for critical audit matters, and would not be expected to include an emphasis paragraph in the auditor's report. Although this did not generate much comment, one commenter affirmed support for the interaction between critical audit matters and emphasis paragraphs. The final standard retains the interaction between critical audit matters and emphasis paragraphs as repropoed.

#### Requirements of Other Regulators and Standard Setters

Under the requirements of other regulators and standard setters, there are no analogous explanatory paragraphs, except for reporting on going concern.

The Board's repropoed approach is similar to the IAASB's approach to the interaction between a paragraph regarding the company's ability to continue as a going concern and key audit matters, although the underlying requirements for auditor reporting on going concern vary.<sup>74</sup> Under the IAASB's approach, an emphasis of matter paragraph is not required for a matter that was determined to be a key audit matter.<sup>75</sup> The EU and the FRC have separate requirements related to going concern reporting that do not specifically address the interaction with their expanded auditor reporting.<sup>76</sup> The IAASB, FRC, and EU do not have requirements for reporting on ICFR.

#### Information About Certain Audit Participants

On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.<sup>77</sup> Firms will be required to file Form AP with the PCAOB for each issuer audit, disclosing this information. In addition to filing Form AP, firms will also have the choice to include this information in the auditor's report.<sup>78</sup> The final standard incorporates the adopted amendments to AS 3101 for situations in which the auditor decides to include information about certain audit participants in the auditor's report. The final standard requires the auditor to use an appropriate section title when providing this information in the auditor's report, but does not require a specific location in the auditor's report.

#### Requirements of Other Regulators and Standard Setters

The IAASB requires the auditor to include the name of the engagement partner in the auditor's report for audits of listed entities.<sup>79</sup> Under EU law, the engagement partner is required to sign

the audit report in all EU countries, including the United Kingdom.<sup>80</sup> Unlike disclosure of the engagement partner's name, disclosure of other accounting firms that participated in the audit is not required by the IAASB, FRC, or the EU.

#### Form of the Auditor's Report

The repropoed standard required the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The repropoed standard did not specify an order for the remaining sections of the auditor's report, which would include explanatory paragraphs and critical audit matters. This approach allowed for consistency in the location of the opinion and basis for opinion sections, with flexibility for the other elements of the auditor's report. The repropoed standard also required titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report.

Commenters were generally supportive of the proposed changes to the form of the auditor's report, because the changes will:

- Enhance the clarity and comparability of disclosures;
- Make it easier for investors to find the opinion since it will be listed first;
- Help facilitate a comparison between auditor's reports; and
- Allow for an appropriate level of flexibility and ease of use without being overly prescriptive.

Some commenters suggested the PCAOB should be consistent with other standard setters in the ordering of section titles in the auditor's report. One commenter expressed concern that the ordering of the components of the opinion and the heading of the critical audit matter section of the report may be misunderstood to imply that critical audit matter communications are separate and distinct from the auditor's opinion, which could be misinterpreted as a piecemeal opinion. In light of the commenter support described above, the Board is adopting the form of the auditor's report as repropoed. As previously discussed, the final standard includes revised introductory language in the auditor's report to avoid the potential misperception that the communication of critical audit matters provides piecemeal opinions.

<sup>74</sup> See paragraph A1 of ISA 570, *Going Concern*, and paragraph 15 of ISA 701.

<sup>75</sup> See paragraph 8 of ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

<sup>76</sup> See ISA (UK and Ireland) 570, *Going Concern*, and see Article 28, *Audit Reporting*, of Directive 2014/56/EU of the European Parliament and of the Council (Apr. 16, 2014).

<sup>77</sup> See PCAOB Release No. 2015-008.

<sup>78</sup> When the auditor divides responsibility for the audit under AS 1205, *Part of the Audit Performed by Other Independent Auditors*, the auditor's report must acknowledge the involvement of the other auditor.

<sup>79</sup> See paragraph 45 of ISA 700.

<sup>80</sup> Directive 2006/43/EC of the European Parliament and of the Council, Article 28, *Audit Reporting* (May 17, 2006).

<sup>73</sup> See existing AS 3101.19.

### Requirements of Other Regulators and Standard Setters

The repropoed approach with respect to the order of the sections of the auditor's report is generally consistent with that of the IAASB.<sup>81</sup> The EU and FRC do not specify an order to the auditor's report.

### Application to Other Audits Performed Under PCAOB Standards

There are situations in which an auditor may be required by law or regulation, or voluntarily agrees, to perform an audit engagement in accordance with PCAOB standards for a company whose audit is not subject to PCAOB oversight.<sup>82</sup> For example, SEC rules permit audits under PCAOB standards in connection with offerings under Regulation A and Regulation Crowdfunding.<sup>83</sup> In these situations, certain elements of the auditor's report required under the final standard, such as the use of "registered public accounting firm" in the title or the statement regarding independence requirements, may not apply. Additional guidance for these situations will be provided.

### Amendments to Other PCAOB Standards

The Board has adopted amendments to several of its existing auditing standards solely to conform to the final standard. The Board is not adopting any further changes to these existing auditing standards at this time, although the Board recognizes that some of the existing auditing standards, such as the redesignated standard AS 3105, may need further updating. The Board may consider proposing further changes to these standards under separate standard-setting projects.

### AS 3105, Departures From Unqualified Opinions and Other Reporting Circumstances

Existing AS 3101.10 and .20-.76 address departures from the auditor's unqualified opinion, such as a qualified opinion, an adverse opinion, or a

disclaimer of opinion, and other reporting circumstances, such as reporting on comparative financial statements. These paragraphs are redesignated as AS 3105.<sup>84</sup> Commenters who addressed this topic generally supported the repropoed amendments to AS 3105, including amending the example auditor's reports to conform with the example auditor's report in the final standard. The Board also received some comments suggesting further changes to AS 3105, such as updating descriptions of and references to accounting requirements that are no longer current<sup>85</sup> and updating certain terminology (e.g., changing references from "entity" to "company"). The Board may consider such updates as part of a separate standard-setting project.

The Board has adopted final amendments to AS 3105 that are substantially similar to the repropoed. The amendments to AS 3105 are not intended to change the circumstances in which the auditor would depart from an unqualified opinion. The changes from the current standard will primarily: (1) Require the communication of critical audit matters in certain circumstances; (2) revise certain terminology to align with the final standard; and (3) amend the illustrative reports for the basic elements of the final standard and the required order of certain sections of the auditor's report.

AS 3105 includes:

#### Communication of Critical Audit Matters in Reports Containing Other Than Unqualified Opinions

a. *Qualified opinion*—Amendments to AS 3105 will require that when the auditor expresses a qualified opinion, the auditor's report also include communication of critical audit matters, if critical audit matter requirements apply.

b. *Adverse opinion*—The existing requirements related to an adverse opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the adverse opinion.

c. *Disclaimer of opinion*—The existing requirements related to a disclaimer of an opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the disclaimer of opinion.

### Requirements of Other Regulators and Standard Setters

Under the IAASB's approach, a matter giving rise to a qualified, adverse, or disclaimer of opinion is by nature a key audit matter.<sup>86</sup> However, in such circumstances: (1) The matter should not be described in the key audit matter section of the auditor's report, (2) the auditor should report on the matter in accordance with applicable standards, and (3) the auditor should include a reference in the key audit matter section to the basis for modified opinion section where the matter is reported.<sup>87</sup> The requirements to determine and communicate key audit matters, other than the matters giving rise to the modified opinion, would still apply when the auditor expresses a qualified or adverse opinion, but not when the auditor disclaims an opinion on the financial statements.<sup>88</sup> The FRC and the EU do not include specific requirements for expanded auditor reporting when the auditor's report contains other than an unqualified opinion.

### Other Amendments to PCAOB Standards

The amendments to other PCAOB standards are substantially as repropoed. These include:

- AS 1220, *Engagement Quality Review*—amending to require the engagement quality reviewer to evaluate the engagement team's determination, communication, and documentation of critical audit matters;
- AS 1301, *Communications with Audit Committees*—amending to require the auditor to provide to and discuss with the audit committee a draft of the auditor's report;
- AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*—amending the example auditor's report to conform with the example auditor's report on the financial statements in the final standard;
- AS 2820, *Evaluating Consistency of Financial Statements*—amending to

<sup>81</sup> See paragraphs 23–28 of ISA 700.

<sup>82</sup> Under the Sarbanes-Oxley Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB oversees the audits of "issuers" and brokers and dealers reporting under Exchange Act Rule 17a-5. See Sarbanes-Oxley Act Section 101. An "issuer" under the Sarbanes-Oxley Act is an entity whose securities are registered under Section 12 of the Exchange Act, or that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed a Securities Act registration statement that has not yet become effective and that it has not withdrawn. See Sarbanes-Oxley Section 2(a).

<sup>83</sup> See Securities Act Form 1-A, Part F/S (b)(2) and (c)(1)(iii); Regulation Crowdfunding Rule 201(t) instruction 9, 17 CFR 227.201(t).

<sup>84</sup> AS 3101.01-.09 and .11-.19 are amended and restated as AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

<sup>85</sup> The Board has issued guidance regarding the status of outdated descriptions of and references to U.S. GAAP in PCAOB standards. See PCAOB, *Staff Questions and Answers, References to Authoritative Accounting Guidance in PCAOB Standards* (Sept. 2, 2009). Among other things, this guidance provides that auditors should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the FASB Accounting Standards Codification ("ASC").

<sup>86</sup> See paragraph 15 of ISA 701.

<sup>87</sup> *Id.*

<sup>88</sup> See paragraph A7 of ISA 701 and paragraph 29 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

include the existing reporting requirements and illustrative explanatory language related to a change in accounting principle or a restatement that is currently in AS 3105; and

- AS 4105, *Reviews of Interim Financial Information*—amending to include the basic elements of the final standard, where applicable.

Conforming amendments were also made to every PCAOB standard that refers to the auditor's report. Commenters generally supported the amendments as reposed.

A commenter suggested revising AS 3305, *Special Reports*, to conform to the example auditor's report in the final standard. Since reports pursuant to AS 3305 are rarely filed with the SEC, as noted by this commenter, the Board does not believe these reports should be updated at this time. As described above, the Board may consider updating this standard as part of a separate standard-setting project.

#### *D. Economic Considerations and Application to Audits of Emerging Growth Companies*

The Board is committed to analyzing the economic impacts of its standard setting. The following discussion addresses the potential economic impacts, including potential benefits and costs, considered by the Board. The Board has sought information relevant to economic consequences several times over the course of the rulemaking. Commenters provided views on a wide range of issues pertinent to economic considerations, including potential benefits and costs, but did not provide empirical data or quantified estimates of the costs or other potential impacts of the standard. The potential benefits and costs considered by the Board are inherently difficult to quantify, therefore the Board's economic discussion is primarily qualitative in nature.

Commenters who discussed the economic analysis in the Board's reproposal provided a wide range of views. Some commenters pointed to academic research for the Board to consider in support of their views. One commenter asserted that the Board's release did not provide a true economic analysis of the pros and cons of mandating the reporting of critical audit matters, but only referenced academic studies on the purported benefits of such reporting. Another argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. The SEC's Investor Advocate said that the Board's

economic analysis made a compelling case as to why the required reporting of critical audit matters would reduce informational asymmetries and add to the total mix of information available to investors.<sup>89</sup> The Board has considered all comments received and has sought to develop an economic analysis that evaluates the potential benefits and costs of the final standard, as well as facilitates comparisons to alternative Board actions.

#### Need for the Rulemaking

##### Critical Audit Matters

Generally, investors and other financial statement users know less about a company's financial performance than do others closer to the financial reporting process, particularly management. This information asymmetry<sup>90</sup> can result in situations where capital is allocated suboptimally. The system of financial reporting in the United States, which requires periodic reporting of information, including annual financial statements, helps address the information asymmetry between investors and management. Board of directors and audit committee oversight of the financial reporting process can further reduce this information asymmetry by enhancing the quality of the information disclosed to the public. As part of this system, the audit of the financial statements also helps reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

Companies' operations continue to become more complex and global. In addition, over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements.<sup>91</sup> These estimates and fair value measurements, which are important to a financial statement user's understanding of the company's financial position and results of operations, can be highly subjective, require significant judgment, and can result in increased measurement uncertainty in financial statements.<sup>92</sup>

<sup>89</sup> See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board's Web site in Docket 034.

<sup>90</sup> Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

<sup>91</sup> See PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014).

<sup>92</sup> See IAASB Project Proposal, Revision of ISA 540, *Auditing Accounting Estimates, Including Fair*

The increased complexity of financial reporting, including the growing use of complex accounting estimates and fair value measurements, may contribute to the information asymmetry between investors and management, despite the fact that management is required to provide significant disclosures to investors and other financial statement users. Some commenters on the reproposal have stated that investors would find information provided by the auditor, an independent third party, particularly relevant in this setting.

As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, the auditor's report has not been expanded to provide this information to investors and generally provides only a standardized pass/fail opinion. Because the auditor's report generally does not contain audit-specific information, it provides very little of the information the auditor knows about the company, its financial reporting, and the challenges of the audit. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the current form of the auditor's report does little to address the information asymmetry between investors and auditors.

The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments will help investors and other financial statement users "consume" the information presented in management's financial statements more effectively. Stated in economic terms, in the Board's view, an expanded auditor's report will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Reducing information asymmetry about the company's financial reporting should lead to a more efficient allocation of capital.

Some commenters supported the reporting of critical audit matters as a means of reducing the information asymmetry between investors and auditors. Other commenters disagreed with the Board's approach and

questioned whether the Board could or should attempt to reduce information asymmetry by requiring expanded auditor reporting. The Board believes that requiring expanded auditor reporting as a means of reducing the information asymmetry between investors and auditors is consistent with its statutory mandate to “protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.”<sup>93</sup> Investors are the intended beneficiaries of the audit, but investors do not receive information about specific work performed during the audit. The final standard seeks to enhance the form and content of the auditor’s report to make it more relevant and informative to investors and other financial statement users.

#### Increasing the Informativeness of the Auditor’s Report To Address Information Asymmetry

The communication of critical audit matters will reduce the information asymmetry between investors and auditors by informing investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgment, including the principal considerations for determining the matters and how the matters were addressed in the audit. The Board believes that auditor reporting of critical audit matters will provide investors with audit-specific information that should facilitate their analysis of the financial statements and other related disclosures. The communication of critical audit matters in the auditor’s report should also help investors and analysts who are interested in doing so to engage management and the audit committee with targeted questions about these issues.<sup>94</sup> Ultimately, while not every critical audit matter will be useful for every investor, broadly, the Board believes that having the auditor provide investors and other financial statements users with additional information about especially challenging, subjective, or complex auditor judgments should help reduce the information asymmetry that exists between investors and management by providing additional insights on the financial statements.

The communication of critical audit matters should also assist investors in

assessing the credibility of the financial statements and, in at least some instances, audit quality.<sup>95</sup> For example, the description of how the auditor addressed the critical audit matter will help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which should allow a deeper and more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have consistently stated that having the auditor rather than the company, provide this type of information would be of added value to investment decision making.<sup>96</sup> Commenting on the reproposal, the SEC’s Investor Advocate noted that investors want to hear directly from the auditor and that this point is confirmed by surveys of professional investors, as well as by certain academic research.<sup>97</sup> This commenter agreed with the premise in the reproposal that, because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility than information provided by management alone.

Reporting of critical audit matters should provide insights that will add to the mix of information that could be used in investors’ capital allocation decisions, for example, by:

- Highlighting the aspects of the financial statement audit that the auditor found to be especially challenging, subjective, or complex;
- Enabling comparison of these aspects of the audit across companies, for example audits of companies within the same industry; and
- Enabling comparison of these aspects of the audit for the same company over time.

<sup>95</sup> It is often not possible to observe the difference between financial reporting quality and audit quality. An academic study conceptually models the path through which the financial reporting and audit processes result in audited financial reporting outcomes. The authors postulate that although audit quality and pre-audit financial reporting quality are distinct constructs, the two processes are often inseparable in terms of observable financial reporting outcomes in archival research. See Lisa Milci Gaynor, Andrea Seaton Kelton, Molly Mercer, and Teri Lombardi Yohn, *Understanding the Relation between Financial Reporting Quality and Audit Quality*, 35 *Auditing: A Journal of Practice & Theory* 1, 1–22 (2016).

<sup>96</sup> See IAG 2011 survey and CFA survey and poll results.

<sup>97</sup> See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board’s Web site in Docket 034 (citing Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors’ Decision to Invest?* 33 *Auditing: A Journal of Practice & Theory* 71, 71–93 (2014)).

Many companies commenting on the reproposal argued that the reporting of critical audit matters would not increase the informativeness of the auditor’s report. For example, several of these commenters claimed that the reporting of critical audit matters would simply duplicate management disclosure without adding additional information, or that critical audit matters would not provide value-relevant information. Other commenters asserted that the reporting of critical audit matters would result in the auditor’s report becoming a lengthy list of boilerplate disclosures, which would contribute to disclosure overload or run contrary to the SEC’s disclosure effectiveness initiative. Several commenters said that critical audit matters could confuse investors if the information in the auditor’s report was duplicative of management’s disclosures but was presented in a different manner, or if the critical audit matter presented information without appropriate context.

By contrast, investor commenters overwhelmingly agreed that the communication of critical audit matters would make the auditor’s report more informative. One commenter said that, although critical audit matters in themselves would not provide investors with all the information needed in the face of growing financial complexity, critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies, form a multifaceted understanding of them, and make informed investment decisions. Another commenter noted that, in jurisdictions where the expanded auditor’s report is available, it is one of the earliest elements of the company’s annual report that they read because it typically highlights the more judgmental elements of the company’s accounting, which often provides insights that form a basis for discussions with management.

#### Mandated Rather Than Voluntary Reporting

Auditors have not developed a practice of providing information in the auditor’s report beyond what is required, even though investors have consistently requested that the auditor’s report become more informative. Current standards provide a framework for auditors to provide limited additional information through emphasis paragraphs,<sup>98</sup> but in general these only point to a disclosure in the company’s financial statements without providing any additional description of

<sup>98</sup> See existing AS 3101.19.

<sup>93</sup> Section 101(a) of Sarbanes-Oxley.

<sup>94</sup> The FRC observes that, in some instances, investors have begun to use the information provided in the expanded auditor’s reports in the U.K. to engage with audit committees. See FRC, *Extended Auditor’s Reports, A Further Review of Experience* (Jan. 2016) (“FRC 2016 Report”).

the matter and, as noted below, emphasis paragraphs are infrequent in practice. Auditor reporting about matters significant to the audit is not prohibited in an emphasis paragraph, but current standards do not encourage auditors to include such information in their report and do not provide a framework for doing so.

There are many other potential reasons why auditors are not providing information voluntarily in the auditor's report, whether about the financial statements or the audit. For example, the historical model of management disclosing information and the auditor attesting to the information may lead companies to resist voluntary additional reporting by the auditor, either through emphasis paragraphs or with respect to information about the audit, which the auditor would be better positioned to communicate than management. Further, auditors may believe that providing additional information could potentially expose them to liability or that doing so could be interpreted as a disclaimer of opinion or a partial opinion as to the identified matters. Finally, in general, there may be disincentives to voluntary reporting if the disclosing party is not able to fully capture the benefits of the disclosures,<sup>99</sup> and parties may also exhibit a bias toward the *status quo*.<sup>100</sup> All of these factors disincentivize auditors from voluntarily providing further information about the audit, even if investors and other financial statement users would respond favorably to receiving additional information.

The Board believes that the required reporting of critical audit matters will promote more complete and consistent disclosure of audit-specific information to financial statement users who may be

interested in it.<sup>101</sup> Mandatory disclosure can also improve the allocative efficiency of capital markets by decreasing the costs associated with gathering information, or by providing market participants with information that otherwise would have been difficult or impossible for them to gather.<sup>102</sup>

#### Additional Improvements to the Auditor's Report

The final standard requires auditors to disclose in the auditor's report the number of years they have served consecutively as the auditor for the company. Although some commenters dispute the value of this information, investor commenters have indicated that the length of the relationship between the auditor and the company would be a useful data point. The growing trend toward voluntary disclosure of this information by companies suggests that increasing numbers of companies believe that the market finds the disclosure useful.<sup>103</sup> Further, there is a line of academic research suggesting that there is an association between auditor tenure and increases or decreases in audit quality.<sup>104</sup>

Although investors may be able to determine auditor tenure by, for example, reviewing past auditor's reports, for many companies the information is not readily available even through a manual search process. Furthermore, while some companies voluntarily provide information about auditor tenure in the proxy statement, many do not. Many companies are also not subject to the proxy rules (for example, most investment companies, foreign private issuers, and many companies whose securities are not listed on a national securities exchange). In cases where the information is provided voluntarily, it is not provided in a consistent location. The Board believes that these issues create unnecessary search costs for investors

who wish to evaluate information about auditor tenure. Mandatory disclosure of auditor tenure in the auditor's report will provide a consistent location for this information and will reduce search costs relative to the current baseline for investors who are interested in auditor tenure, especially in the case of companies that do not voluntarily provide such information or for which the information is not available through the EDGAR system. Mandatory disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The existing auditor's report also does not describe important aspects of the auditor's responsibilities under existing auditing standards, such as the auditor's responsibility to detect material misstatements, whether due to error or fraud; the auditor's responsibility for the notes to the financial statements; and the auditor independence requirement. This may contribute to misperceptions by investors and other financial statement users about the auditor's role and responsibilities, including with respect to these matters. Academic research suggests that there are a number of ways in which investor perceptions of the role and responsibilities of the auditor may diverge from what current professional standards require.<sup>105</sup> In addition, the existing standards do not require a uniform approach to basic content, such as the addressee of the report and the form of the auditor's report, which may increase the time and costs of processing the information in the auditor's report. The final standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.

Commenters generally supported the repropose changes to these basic elements of the auditor's report. Some commenters noted that the enhanced descriptions of the auditor's responsibility to detect material misstatements would clarify the auditor's responsibilities for financial

<sup>99</sup> Academic research finds that there are certain situations in which disclosure may be socially optimal but not privately optimal. Auditors and companies may resist voluntary expanded auditor reporting because of concerns that certain types of spillover effects (or externalities) may create a competitive disadvantage. For a summary of this line of research, see Luigi Zingales, *The Future of Securities Regulation*, 47 *Journal of Accounting Research* 391, 394–395 (2009). Professor Zingales is the founding director of the PCAOB's Center for Economic Analysis, now known as the Office of Economic and Risk Analysis. The research cited above was published before he joined the PCAOB.

<sup>100</sup> Research in behavioral economics suggests that when facing a set of decisions, individuals are more likely to stick to the known outcome (*status quo*) than would be expected based on the theory of rational decision making under uncertainty. There are a variety of reasons why individuals may choose the status quo outcome in lieu of an unknown outcome, including aversion to the uncertainty inherent in moving from the status quo to another option. See William Samuelson and Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 *Journal of Risk and Uncertainty* 7, 7–59 (1988).

<sup>101</sup> Academic research on disclosure explores these types of positive externalities, as well as certain negative externalities. See, e.g., Ronald A. Dye, *Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities*, 65 *The Accounting Review* 1, 1–24 (1990); or Anat R. Admati and Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 *The Review of Financial Studies* 479, 479–519 (2000).

<sup>102</sup> See, e.g., John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 *Virginia Law Review* 717, 717–753 (1984).

<sup>103</sup> See Center for Audit Quality and Audit Analytics, 2016 Audit Committee Transparency Barometer (Nov. 2016). See also Ernst & Young, *Audit Committee Reporting to Shareholders 2016* (Sept. 2016).

<sup>104</sup> See below for a discussion of academic research regarding auditor tenure.

<sup>105</sup> See, e.g., Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 *Accounting Horizons* 69, 69–90 (2008); Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 *Accounting Horizons* 659, 675–676 (2011); or Theodore J. Mock, Jean Bédard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 *Auditing: A Journal of Practice & Theory* 323, 323–351 (2013).



statement users, other commenters offered suggestions for refinement, such as aligning the requirements to the IAASB model or amending the description to more clearly define the auditor's role within the context of the financial reporting regulatory framework.

Commenters also generally supported including a statement on the auditor's independence requirement. For example, some commenters stated that adding a statement by the auditor on their independence would reinforce investors' understanding of the auditor's requirement to remain independent and objective in expressing the audit opinion. Other commenters said that the enhanced description of the independence requirement could provide a meaningful reminder of the importance of auditor independence. However, other commenters said that the enhanced description of auditor independence was either unnecessary, or would not have a significant impact on auditor behavior. Based on broad commenter support, the Board is adopting these additional improvements to the auditor's report as repropoed.

#### Baseline

#### Critical Audit Matters

The auditor's report in the United States today generally consists of three paragraphs that include limited audit-specific information. The existing auditor's report identifies the company's financial statements that were audited, provides a standardized description about the nature of an audit, and provides an opinion on whether the company's financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework. The auditor's report is often described as a pass/fail model because the report only conveys the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail) and typically provides limited information about the nature of the work on which the opinion is based.

The Board's current standards also require that the auditor add explanatory paragraphs to the auditor's report under specific circumstances, such as when there is substantial doubt about the company's ability to continue as a going concern or a restatement of previously issued financial statements. When included, these paragraphs generally consist of standardized language that provides limited audit-specific information.

The auditor may also, at his or her discretion, include emphasis paragraphs

in the auditor's report to emphasize a matter regarding the financial statements. Generally, an emphasis paragraph only points to a disclosure in the company's financial statements without providing any additional description. Under current practice, emphasis paragraphs are infrequent.<sup>106</sup> Auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.<sup>107</sup>

Academic research confirms the view of the Board and many commenters that the current form of the auditor's report conveys little of the audit-specific information obtained and evaluated by the auditor.<sup>108</sup> Academic research also finds that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified because it does not provide much additional informational value about a particular audit.<sup>109</sup> These findings align with the consistent call from investors, over the course of the Board's rulemaking process, for a more informative auditor's report.<sup>110</sup>

#### Additional Improvements to the Auditor's Report

The existing auditor's report is not required to have a specified addressee but it may be addressed to the company whose financial statements are being audited, its board of directors, or

<sup>106</sup> In the audit reports of approximately 6,350 issuers with fiscal year 2014 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 2 percent of the filings.

<sup>107</sup> See paragraph .10 of AI 20, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710*.

<sup>108</sup> See Church et al., *The Auditor's Reporting Model: A Literature Overview and Research Synthesis* 69–90.

<sup>109</sup> See Gray et al., *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors* 659–684; Mock et al., *The Audit Reporting Model: Current Research Synthesis and Implications* 323–351.

<sup>110</sup> Academic research has found that, in some instances, the inclusion of explanatory language in the auditor's report may provide investors with additional value-relevant information. A recent academic study suggests that auditor's reports containing certain types of explanatory paragraphs required under existing standards may provide information about the likelihood that financial statements will be subsequently restated. The authors argue that the inclusion of such an explanatory paragraph in the auditor's report can provide a signal to investors about the risk of misstatement of the company's financial statements. See Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increased Financial Misstatement Risk?* 89 *The Accounting Review* 2115, 2115–2149 (2014).

stockholders.<sup>111</sup> Under current practice, the auditor's report is generally addressed to one or more of the following: (1) The board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.<sup>112</sup>

The current auditor's report also includes the report title, the date, and the name and location of the accounting firm's office issuing the report. The auditor is not currently required to disclose in the auditor's report the number of years it has served as auditor for the company. However, as noted earlier, many larger companies have begun voluntarily disclosing auditor tenure in the proxy statement.

Currently, the title of the auditor's report, "Report of Independent Registered Public Accounting Firm," provides the only indication of the auditor's independence.

#### Benefits

##### Critical Audit Matters

Economic theory commonly attributes two benefits to mandatory disclosure. First, the disclosure of previously unknown, value-relevant information directly benefits the market because it allows market participants to make better-informed decisions. Second, the disclosure of such information may indirectly benefit the market because some parties may change their behavior in positive ways after information is disclosed.

##### Direct Benefit: More Informative and Useful Auditor's Report

The Board believes that auditor communication of critical audit matters will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Some commenters on the reproposal agreed that the information provided in critical audit matters would be used by various types of investors in a number of different ways that are consistent with the framework outlined in the reproposal:

- *Informing*—Identification of the matters arising from the audit that the auditor considered especially challenging, subjective, or complex,

<sup>111</sup> See existing AS 3101.09.

<sup>112</sup> This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers, benefit plans, and brokers and dealers.

together with a description of how the auditor addressed those matters, which should provide valuable information. For example, some commenters said that:

- Critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies and make investment decisions;

- Investors would use critical audit matters in the same way that they use any other financial disclosure; critical audit matters would add an additional perspective to management's disclosures;

- Insights on critical audit matters may be relevant in analyzing and pricing risks in capital valuation and allocation;

- Critical audit matters would inform investor models of company financial performance;

- Critical audit matters would augment and add more dimension to the information provided by the financial statements and the critical accounting policies and estimates; and

- The communication of critical audit matters would lower the cost of acquiring information for financial statement users.

- *Framing*—Critical audit matters should provide investors with a new perspective on the financial statements and focus their attention on the related financial statement accounts and disclosures, which should facilitate their analysis of the financial statements, and help them assess financial performance, for example by highlighting potentially relevant information or by reducing the costs to process or search for the information. For example, some commenters said that:

- Critical audit matters would focus investors' attention on key financial reporting issues and identify areas that deserve more attention;

- In jurisdictions where expanded auditor reporting is available, it focuses users' attention on issues that would be pertinent to understanding a company as a long-term investor; and

- Information in critical audit matters would contribute to investor understanding and consumption of information in the financial statements.

- *Monitoring*—The ability to identify and evaluate the matters identified as critical audit matters should also help investors and analysts engage management with targeted questions about these issues and support investor decisions on ratification of the auditor. For example, some commenters said that:

- Critical audit matters would facilitate the ability of investors to monitor management's and the board of director's stewardship of the company by highlighting accounting and auditing issues and other matters that investors may wish to emphasize in their engagement with management; and

- Critical audit matters would provide important information on how the auditor has addressed an issue, which investors can use in evaluating the rigor of the audit and making proxy voting decisions, including ratification of the audit committee's choice of external auditor.

Critical audit matters may be used by different types of investors in different ways. For example, retail investors (or others who may act on their behalf, such as analysts, credit rating agencies, or the financial press) may use the additional information to help them identify and analyze important aspects of the financial statements. Larger investors, on the other hand, may also use critical audit matters as a basis for engagement with management.

The communication of critical audit matters aims to provide investors and financial statement users with specific information about the audit of a company's financial statements. Some commenters were concerned, however, that the communication of critical audit matters could lead to a reduction in comparability of auditor's reports. Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, to the extent the information provided is useful in evaluating the financial performance, highlighting these differences should contribute to the overall mix of information. Further, some commenters on the proposal said that investors are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditor's reports across companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or MD&A that is specific to a company or a reporting period.

A body of academic research regarding the possible effects of expanded auditor reporting is emerging.<sup>113</sup> The Board has been monitoring this research with a view towards assessing its potential relevance

to this rulemaking. The Board is mindful of several issues that limit the extent to which this research can inform its decision making. Much of this research is unpublished and at a relatively early stage. The current conclusions may be subject to multiple interpretations and it is possible that results from this research may be revised during the peer review process. Moreover, it may be difficult to generalize results outside the context of specific studies. For example, in considering the implications of academic studies based on data from other jurisdictions, differences between the Board's final standard and the requirements in other jurisdictions must be taken into account. In addition, specific characteristics of the U.S.-issuer audit market may make it difficult to generalize observations made in other markets because of differences in baseline conditions (for example, market efficiency, affected parties, policy choices, legal environment, and regulatory oversight). As to experimental research in particular, it should be noted that the experimental setting may not provide study participants with information that is representative of the information environment in which market participants actually operate; for instance, if new information appeared more salient to study participants than it would to a market participant, the impact of expanded auditor reporting would be overstated in an experimental setting. In addition, some of these studies were conducted based on earlier versions of rule text that differs from the final standard, which may affect the extent to which the results can inform the Board in evaluating potential effects of the final standard.

As discussed in more detail in the economic analysis contained in the reproposal, the results from early research analyzing the informational value of expanded auditor reporting are inconclusive.<sup>114</sup> Some studies found that expanded auditor reporting could provide investors with new and useful information, while other studies found that the benefits attributable to expanded auditor reporting were not statistically significant, but that it could produce unintended consequences. These limited findings may be due to the fact that the results of the studies represent averages for large samples of companies. On average, investors may already have access to a variety of information sources (such as annual reports, news media, and analyst

<sup>113</sup> For a review of relevant academic research, see Jean Bédard, Paul Coram, Reza Espahbodi, and Theodore J. Mock, *Does Recent Academic Research Support Changes to Audit Reporting Standards?* 30 *Accounting Horizons* 255, 255–275 (2016).

<sup>114</sup> See PCAOB Release No. 2016–003, Section VI.C.1.a.

research reports) which may contain similar information about a company. However, expanded auditor reporting may be relatively more informative for companies where alternative sources of information are less available (e.g., those companies with less analyst coverage).

In response to the reproposal, two commenters submitted studies suggesting that expanded auditor reporting has increased the informative value of the auditor's report. One experimental study tested the communicative value of expanded auditor reporting by analyzing how key audit matters affected investment professionals' assessment of a company's business economics, as well as their confidence in making that assessment.<sup>115</sup> The authors found that specific informational content of the key audit matter affected the study participants' perceived level of trust associated with the auditor's report, which then affected the perceived level of trust associated with the financial statements and their assessment of the company's business economics. Another study analyzed whether the communicative value of auditor's reports changed following the implementation of expanded auditor reporting in the United Kingdom.<sup>116</sup> The author found that the readability of auditor's reports increased in the post-implementation period, and that the use of negative and uncertain words in expanded auditor's reports captured more client-specific audit risk.<sup>117</sup> In addition, the author found limited evidence that the dispersion of analysts' EPS forecasts decreased following the implementation of expanded auditor reporting, suggesting an improved information environment. The author argued that expanded auditor reporting was successful at increasing the communicative value of the auditor's report, and that analyst behavior changed accordingly. In contrast, another recent experimental study found that including critical audit matters reduced the readability of the auditor's report but did not

<sup>115</sup> See Annette Koehler, Nicole Ratzinger-Sakel, and Jochen Theis, *Does the Reporting of Key Audit Matters Affect the Auditor's Report's Communicative Value? Experimental Evidence from Investment Professionals* (working paper submitted as comment letter No. 18, available on the Board's Web site in Docket 034).

<sup>116</sup> See Kecia Williams Smith, *Tell Me More: A Content Analysis of Expanded Auditor Reporting in the United Kingdom* (working paper submitted as comment letter No. 71, available on the Board's Web site in Docket 034).

<sup>117</sup> The author uses several measures designed to assess the readability of texts which, the study notes, have been used in several other published academic studies addressing the readability of financial disclosure. See *id.* at 5.

incrementally inform nonprofessional investors' valuation judgments. However, the study suggested that the reporting of a critical audit matter lowers nonprofessional investors' perceptions of management's credibility when earnings just meet analysts' expectations. The study was designed and implemented using the definition of critical audit matters and related reporting requirements from the Board's proposal, which differ from the final standard.<sup>118</sup>

In addition, in reviewing the experience of expanded auditor reporting in the United Kingdom, the FRC observed that investors greatly value the information provided in expanded auditor reporting.<sup>119</sup> This view is confirmed by UK investors that commented on the reproposal. The FRC noted that, in the two years following the implementation of the new requirements, an association of investment managers has recognized in an annual awards ceremony those specific auditor's reports found to be most clear and most innovative in providing insight into the audit of the company's financial statements.<sup>120</sup> In addition, the FRC notes that users of the new auditor's reports identified certain descriptions of risks that they found to be more useful—such as descriptions that are specific to the entity being audited. Further, the FRC report noted that, in the second year of implementation, a much greater proportion of risks were set out in a more meaningful and transparent way.<sup>121</sup> As noted above, the FRC's requirements for expanded auditor reporting are different from the final standard, and the baseline legal and regulatory environment is not the same as in the United States. Nevertheless, the Board believes that there are sufficient similarities for the UK experience to be generally informative in its decision-making.

While it is too early for the body of academic research on expanded auditor reporting to provide a conclusive answer, investors commenting during the Board's standard-setting process have consistently affirmed the usefulness of expanded auditor reporting and the FRC's observations on the early experience of investors in the

<sup>118</sup> See Brian Carver and Brad Trinkle, *Nonprofessional Investors' Reactions to the PCAOB's Proposed Changes to the Standard Audit Report* (March 2017) (working paper, available in Social Science Research Network).

<sup>119</sup> See FRC 2016 Report.

<sup>120</sup> See FRC, *March 2015—Extended Auditor's Reports, A Review of Experience in the First Year*; and FRC 2016 Report.

<sup>121</sup> *Id.*

United Kingdom are consistent with this view. Accordingly, the Board believes that auditor communication of critical audit matters will add to the mix of information that investors can use.

#### Indirect Benefit: Improved Audit and Financial Reporting Quality

In general, information asymmetry can lead to situations in which an agent (such as an auditor) takes actions that do not coincide with the best interests of the principal (such as an investor), if the agent's incentives are misaligned.<sup>122</sup> This type of problem is the result of the inability of the principal to observe or monitor the agent's behavior, which also inhibits the principal's ability to identify and reward optimal behavior, or punish sub-optimal behavior. Economic theory posits that the disclosure of information can have indirect effects that lead to changes in behavior.<sup>123</sup> In the context of expanded auditor reporting, the additional information provided in the auditor's report could be beneficial to investors by providing more information about the audit, which could affect their voting decisions. To the extent that this could influence the terms of the auditor's engagement, academic research suggests "any additional information about the agent's action, however imperfect, can be used to improve the welfare of both the principal and the agent."<sup>124</sup>

This suggests that making aspects of the audit more visible to investors through the communication of critical audit matters should provide some auditors, management, and audit committees with additional incentives to change their behavior in ways that may enhance audit quality and ultimately financial reporting quality. For instance, the communication of critical audit matters could lead:

- Auditors to focus more closely on the matters identified as critical audit matters;
- Audit committees to focus more closely on the matters identified as critical audit matters and to engage the

<sup>122</sup> Economists use principal-agent theory to analyze situations where one party (the principal) hires another party (the agent) to perform certain tasks and decision-making ability is delegated to the agent. For a general discussion of principal-agent theory, see, e.g., Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *Journal of Financial Economics* 305, 305–360 (1976), or Bengt Holmstrom, *Moral Hazard and Observability*, 10 *The Bell Journal of Economics* 74, 74–91 (1979).

<sup>123</sup> See, e.g., George Loewenstein, Cass R. Sunstein, and Russell Golman, *Disclosure: Psychology Changes Everything*, 6 *Annual Review of Economics* 391, 391–419 (2014).

<sup>124</sup> See Holmstrom, *Moral Hazard and Observability* at 75.

auditor and management about the adequacy of the related disclosures; and

- Management to improve the quality of their disclosures because they know that investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters.

The communication of critical audit matters could lead auditors to increase their focus on the matters identified in the auditor's report as critical audit matters. As suggested by commenters, the communication of critical audit matters could further incentivize auditors to demonstrate the level of professional skepticism necessary for high quality audits in the areas of the critical audit matters. Other commenters stated that the reporting of critical audit matters could result in increased audit quality. For example, auditors could feel that the potentially heightened scrutiny of the matters identified as critical audit matters may warrant additional effort to satisfy themselves that they have obtained an appropriate amount of audit evidence to support their opinion.

The communication of critical audit matters could also heighten management's attention to the relevant areas of financial statements and related disclosures. Several commenters stated that the reporting of critical audit matters would lead management to improve the quality of their disclosures or adopt more widely accepted financial reporting approaches in these areas.<sup>125</sup>

An experimental study analyzed the joint effect of expanded auditor reporting and audit committee oversight on management disclosure choices.<sup>126</sup> The author found that the study participants, who were currently serving as public company financial executives, chose to provide the greatest level of disclosure when they knew that the auditor's report would provide a more detailed description of the accounting estimate, and the audit committee exhibited strong oversight. The author argued that, similar to what other academic research has found regarding the resolution of audit adjustments, information presented in critical audit

matters would be the outcome of a negotiation process between the auditor and management.

Increased management attention to the related aspects of the financial statement accounts and disclosures described in the critical audit matters should, at least in some cases, lead to an incremental increase in the quality of the information presented. Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.<sup>127</sup>

In addition, the communication of critical audit matters may enhance the audit committee's oversight efforts by providing an additional incentive for the audit committee to engage with the auditor and management about the matters identified as critical audit matters and the adequacy of the company's related disclosures. Although some commenters stated that the required communication of critical audit matters would "chill" communications between the auditor and the audit committee, others said that it would enhance communications between these parties. Further, it should be noted that the final standard does not change the Board's existing requirements on audit committee communications, other than requiring the auditor to provide the audit committee with a draft of the auditor's report.

To the extent changes in the behavior of auditors, audit committees, and management occur, they could lead to an incremental increase in audit quality and financial reporting quality, which should increase investors' confidence in the reliability of the financial statements. Some commenters stated that a more transparent and informative auditor's report could heighten user confidence in the audit and the audited financial statements. Academic research suggests that an increase in investor confidence should decrease the average cost of capital.<sup>128</sup> As discussed in the economic analysis of the reproposal, some empirical studies conducted in other jurisdictions provide evidence

that expanded auditor reporting increased audit quality, while other studies found that it did not have a measurable effect on audit quality.<sup>129</sup> The Board is not aware of any empirical studies indicating that expanded auditor reporting had a negative effect on audit quality.

#### Indirect Benefit: Differentiation Among Auditor's Reports

If investors and other financial statement users perceive and respond to differences in the quality and usefulness of the information communicated by auditors regarding critical audit matters, expanded auditor reporting should serve as a potential means of greater differentiation among accounting firms and engagement partners.<sup>130</sup> One commenter stated that the reporting of critical audit matters would allow auditors to differentiate themselves, and that this differentiation would provide useful information to investors and other financial statement users. If expanded auditor reporting allows investors to differentiate among accounting firms and engagement partners, it should provide a more nuanced signal of audit quality and financial reporting reliability.

The FRC report also noted that there are clear differences among accounting firms in the approaches taken to implement the requirements.<sup>131</sup> For example, one firm went beyond the FRC's requirements by including audit findings for the risks of material misstatement in the majority of its auditor's reports in the second year of implementation, which other firms did far less frequently. The FRC's observations may suggest that accounting firms took different approaches to expanded auditor reporting as a means of distinguishing themselves based on the quality and usefulness of the information provided in their auditor's reports. Furthermore, as discussed in the economic analysis of the reproposal, an academic study argued that investors found the auditor's reports issued by some accounting firms to be more useful than others.<sup>132</sup> One commenter specifically noted that mandatory auditor rotation was introduced in the UK at the same time

<sup>125</sup> To substantiate this point, one commenter cited a memo prepared for the clients of an international law firm that noted management should consider revising or supplementing their own disclosures relating to issues raised in expanded auditor's reports to ensure that the totality of disclosures around the issue are complete and accurate. See Sullivan & Cromwell LLP, *Audit Reports, PCAOB Releases Reproposal of Amendments to Its Audit Report Standard* (May 25, 2016).

<sup>126</sup> See Stephen H. Fuller, *The Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Management Financial Disclosure Decisions* (working paper submitted as comment letter No. 49, available on the Board's Web site in Docket 034).

<sup>127</sup> See, e.g., Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 1–29 (2012). Professor Leuz is an economic advisor at the PCAOB. The research cited above was published before he joined the PCAOB.

<sup>128</sup> See Luigi Guiso, Paola Sapienza, and Luigi Zingales, *Trusting the Stock Market*, 63 *The Journal of Finance* 2557, 2557–2600 (2008). Professor Zingales is the Founding Director of the PCAOB's Center for Economic Analysis, now known as the Office of Economic and Risk Analysis. The research cited here was published before he joined the PCAOB.

<sup>129</sup> See PCAOB Release No. 2016–003, Section VI.C.1.b, footnotes 154–156 and accompanying text.

<sup>130</sup> On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. See PCAOB Release No. 2015–008.

<sup>131</sup> See FRC 2016 report.

<sup>132</sup> See PCAOB Release No. 2016–003, Section VI.C.1.b, footnote 161 and accompanying text.

as expanded auditor reporting, and that this may have provided accounting firms with motivation to differentiate themselves.

In addition to relying on the audit committee (which, at least for exchange-listed companies, is charged with overseeing the external auditor), in the absence of differentiation based on the auditor's report, users of financial statements may rely on proxies such as the reputation of the accounting firm issuing the auditor's report, aggregated measures of auditor expertise (for example, dollar value of issuer market capitalization audited or audit fees charged), or information about the geographic location of the office where the auditor's report was signed as signals for audit quality. Academic research finds, however, that these are imperfect signals of audit quality.<sup>133</sup>

The identification and description of critical audit matters should permit differentiation among auditor's reports based on investor perceptions of their informativeness and usefulness. In some instances it may also provide a signal of audit quality. Because the determination and communication of critical audit matters may reflect a variety of considerations, however, critical audit matters may not bear directly on audit quality. For example, the choice of which critical audit matters to communicate or how to describe them may reflect considerations such as the company's business environment and financial reporting choices, accounting firm methodology, engagement partner characteristics, and legal advice. Thus, a more detailed description of critical audit matters may not necessarily reflect a higher quality audit than a less informative description of such matters.

Nevertheless, informative descriptions of how the audit addressed critical audit matters should provide insight into the extent and appropriateness of the auditor's work. Moreover, it is possible that thoughtful, audit-specific, and useful critical audit matters (or, conversely, generic and uninformative critical audit matters) could affect investor perceptions of the auditor's work and willingness to provide useful information. As a result, the communication of critical audit matters, potentially in conjunction with disclosures regarding the identity of the engagement partner and other accounting firms that participated in the

audit,<sup>134</sup> and other relevant information should enable differentiation among engagement partners and accounting firms on that basis.

#### Additional Improvements to the Auditor's Report

The final standard will introduce new requirements regarding auditor tenure, the addressee of the auditor's report, and statements in the auditor's report related to auditor independence and the auditor's responsibility for reporting on ICFR.<sup>135</sup> In addition, the final standard contains other changes to the form of the auditor's report, which are intended to improve and clarify the language for certain elements, such as statements related to the auditor's responsibilities regarding the notes to the financial statements, and to promote a consistent presentation of this information across auditor's reports.

Investor commenters have consistently supported disclosing tenure in the auditor's report. In the Board's view, which is consistent with the views of some commenters,<sup>136</sup> disclosing information about auditor tenure in the auditor's report will provide a consistent location for this information and decrease the search costs, relative to the current environment of voluntary reporting, for some investors and other financial statement users who are interested in this information.

The statement regarding the auditor's existing obligation to be independent of the company is intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations. By requiring the auditor's report to be addressed to certain parties, the Board will be promoting uniformity in the addressees of the auditor's report.

Commenters were generally supportive of the proposed changes to the form of the auditor's report. For example, some commenters stated these enhancements would make the auditor's report easier to read and would facilitate comparisons between auditor's reports for different companies by providing a consistent format.

<sup>134</sup> See PCAOB Release No. 2015-008.

<sup>135</sup> In circumstances where management is required to report on ICFR but the auditor is not and has not performed an audit of ICFR, the final standard requires a statement to that effect in the auditor's report.

<sup>136</sup> See below for a discussion of academic research regarding auditor tenure.

#### Costs and Potential Unintended Consequences

##### Costs

Commenters on the reproposal raised concerns that the rule would impose various types of costs, but generally did not quantify those costs. Even those that, at an earlier stage of the rulemaking, conducted limited implementation testing of the proposal were unable to provide a quantified cost estimate. Given lack of data, the Board is unable to quantify costs, but provides a qualitative cost analysis.

As an additional means of assessing potential cost implications of the final standard, PCAOB staff has reviewed data from the first year of implementation of expanded auditor reporting in the United Kingdom.<sup>137</sup> As discussed below, staff analyzed a variety of data points that may be associated with potential costs, including audit fees, days required to issue the auditor's report, and the content of the expanded auditor's report. It should be noted that it may be difficult to generalize observations from the UK experience. For example, the reporting and documentation requirements relating to expanded auditor's reports in the United Kingdom differ from those in the final standard, the baseline legal environments are different, and the UK requirements apply only to companies with a premium listing on the London Stock Exchange and not, for example, to smaller companies that list on London's AIM market.

##### Critical Audit Matters

The Board anticipates that the final requirements regarding critical audit matters will have potential cost implications for auditors and companies, including their audit committees. Such costs will likely relate to additional time to prepare and review auditor's reports, including discussions with management and audit committees, as well as legal costs for review of the information provided in the critical audit matters. In addition, auditors may choose to perform more audit procedures related to areas reported as critical audit matters (even though performance requirements have not changed in those areas), with cost implications for both auditors and companies.

For auditors, costs might represent both one-time costs and recurring costs. One-time costs could be incurred as a

<sup>137</sup> See PCAOB, *White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700* ("PCAOB White Paper") (May 2016), available on the Board's Web site in Docket 034.

<sup>133</sup> See, e.g., Jere R. Francis, *A Framework for Understanding and Researching Audit Quality*, 30 *Auditing: A Journal of Practice & Theory* 125, 125-152 (2011) and Mark DeFond and Jiaying Zhang, *A Review of Archival Auditing Research*, 58 *Journal of Accounting and Economics* 275, 275-326 (2014).

result of: (1) Updating accounting firm audit and quality control methodologies to reflect the new reporting requirements; and (2) developing and conducting training of accounting firm personnel on the new reporting requirements. When updating methodologies, some accounting firms will likely also develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters. One commenter suggested that the initial implementation costs could place a significant and possibly disproportionate burden on smaller accounting firms.

Recurring costs will primarily reflect additional effort expended in individual audits. The final standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which will be based on work the auditor has already performed. However, there will be some additional recurring costs associated with drafting descriptions of critical audit matters and related documentation. It is likely that senior members of the engagement teams, such as partners and senior managers, will be involved in determining the critical audit matters and developing the language to be included in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office, will also result in recurring costs. Additional time might also be incurred by the auditor as a result of discussions with management or the audit committee regarding critical audit matters.

Companies, including audit committees, will likely also incur both one-time and recurring costs as a result of the final standard. One-time costs could be incurred, for example, in educating audit committee members about the requirements of the new standard and in developing management and audit committee processes for the review of draft descriptions of critical audit matters and the related interaction with auditors. Recurring costs will include the costs associated with carrying out those processes, as well as any increase in audit fees associated with the new reporting requirements or legal fees stemming from a review of critical audit matter communications.

If the drafting and review of critical audit matter reporting takes place towards the end of the audit, there will also be an opportunity cost associated with the time constraints on the parties involved (including, for example,

management, the engagement partner, the audit committee, and the auditor's and company's respective legal counsel). The end of the audit is a busy period in which multiple issues may need to be resolved before the auditor's report can be issued. At the same time, companies and management may also be in the process of finalizing the annual report. Time spent drafting and reviewing the communication of critical audit matters could occur at the same time as other important work in the financial reporting and audit process, and would likely involve senior management that command relatively high annual salaries or experienced auditors and lawyers with relatively high hourly billing rates. In addition, the communication of critical audit matters could lead to changes in management's disclosures, which may result in more effort and cost in the financial reporting process.

Several commenters on the reproposal claimed that the required reporting of critical audit matters would lead to increased audit fees, but none provided data or estimates regarding the magnitude of the increases they expected. Commenters on the proposal had differing views about the likely magnitude of direct costs associated with auditor reporting of critical audit matters. Some commenters said that there would not be material additional costs for communication of critical audit matters, as these matters would already have been communicated to the audit committee. This may suggest that a substantial amount of the work required to communicate critical audit matters would already have been completed earlier in the audit.

One commenter argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. Some commenters noted that investors would be expected to ultimately bear the cost of the audit, and these commenters have voiced strong support for expanded auditor reporting since the project's inception. This suggests that they consider the benefits of expanded auditor reporting to justify the costs, and would support additional fees for additional useful information.

Audit fees do not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms choose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting. Subject to those limitations,

in its review of the implementation of expanded auditor reporting in the United Kingdom, the PCAOB staff did not find evidence of statistically significant increases in audit fees following the first year of expanded auditor reporting.<sup>138</sup> For 53 percent of the companies analyzed, audit fees for the year of implementation remained the same or decreased as compared to the prior year's audit fees. Audit fees increased for the remaining companies. The PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent, roughly consistent with the findings of academic research described in the economic analysis in the reproposal. However, the staff found that the median change in audit fees was zero. Collectively, these results seem to suggest that outlier companies with relatively large increases in audit fees drove the result for the average change in audit fees. It should be noted that the PCAOB staff's review did not analyze whether other factors, such as inflation, changes in the economic environment and corporate risk, corporate acquisitions, or the implementation of other regulatory changes, contributed to the documented increase in audit fees.

One commenter on the reproposal noted that the caveats described above are important because the inability to fully gauge the costs of expanded auditor reporting could lead the Board to underestimate the costs associated with the rule, which may bear disproportionately on smaller companies and their auditors. Another commenter also asserted that the costs of expanded auditor reporting are likely to be disproportionately borne by smaller companies because the repropounded rule had, in their estimation, limited scalability. The Board believes that the complexity and costs associated with determining, documenting, and communicating critical audit matters should generally depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

#### Additional Improvements to the Auditor's Report

The changes adopted to the basic elements of the auditor's report do not represent a significant departure from the reproposal. Some of the enhanced basic elements will have cost implications for auditors, although these costs are not expected to be significant. One-time costs will primarily relate to updating methodology and training and

<sup>138</sup> *Id.*

the initial determination of the first year the auditor began serving consecutively as the company's auditor. Based on comments received, it does not appear that the changes adopted to the basic elements will impose significant recurring costs, because the year in which tenure began will not change and the other amendments involve standardized language that, once implemented, will be the same or very similar across different auditor's reports every year.

#### Potential Unintended Consequences Time Needed To Issue the Auditor's Report

As a result of the additional effort required to determine, communicate, and document critical audit matters, some commenters said that it would take auditors longer to issue their reports. On this point, the PCAOB staff study did not find evidence that compliance with the United Kingdom's expanded auditor reporting requirements delayed the issuance of auditor's reports in the first year of implementation. Based on the study, for companies that had three years of financial statements, a new form auditor's report was issued, on average, in 63 days from the company's fiscal year end date in the year of implementation, as compared to 64 days in the prior year and 65 days two years earlier. Further, academic research cited in the economic analysis of the reproposal similarly did not find that the UK reporting requirements led to delays in financial reporting.<sup>139</sup>

#### Number and Content of Critical Audit Matters

Some commenters indicated an expectation that the auditor's report would include a long list of critical audit matters or that auditors would have incentives to communicate an overly long list of critical audit matters. For example, some commenters said that this would occur because the auditor would be motivated to communicate as much as possible in an effort to mitigate any future liability for unidentified critical audit matters, or as a means to avoid potential consequences of being second-guessed by regulators or others. Other commenters asserted that such a development could make the auditor's report overly long, contributing to disclosure overload and conflicting with the SEC's disclosure effectiveness project. Other commenters indicated that expanded auditor reporting could

lead to boilerplate language that would diminish the expected value of the critical audit matters and obscure the clarity of the auditor's opinion. If auditors fail to provide audit-specific information, the communication of critical audit matters will not decrease information asymmetry about the audit, and may obscure other important information included in the auditor's report and the audited financial statements.

The final requirements aim to provide investors with the auditor's unique perspective on the areas of the audit that involved the auditor's especially challenging, subjective, or complex judgments. Limiting critical audit matters to these areas should mitigate the extent to which expanded auditor reporting could become standardized. Focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. Also, while some commenters argued that liability concerns would increase the number of critical audit matters auditors communicate, others suggested that liability concerns would minimize the additional statements auditors make.

The PCAOB staff study did not find evidence that expanded auditor reporting in the United Kingdom resulted in a very large number of risk topics or none at all in the first year of implementation.<sup>140</sup> On average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight. Additionally, the descriptions of the risks of material misstatement in the auditor's reports in the first year of implementation were not presented in standardized language, but included variations in content length, description, and presentation. The most frequently described risk topics related to revenue recognition, tax, and goodwill and intangible assets. The FRC report on the first two years of expanded auditor reporting in the United Kingdom finds a similar range and average number of risk topics disclosed in both the first and second year of implementation.<sup>141</sup> The FRC report also finds disclosure of similar risk topics in the second year of implementation of expanded auditor reporting in the United Kingdom.<sup>142</sup>

Further, the FRC found that, in the second year of expanded auditor reporting in the United Kingdom, the discussion of risks has improved relative to the first year of

implementation and that the majority of auditor's reports provided discussion of risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.<sup>143</sup> These findings suggest that, thus far, expanded auditor reporting has not become standardized in the United Kingdom.<sup>144</sup>

#### Effects of Increased Attention to Critical Audit Matters

The communication of critical audit matters could lead auditors, company management, and the audit committee to spend additional time and resources on reviewing the adequacy of the work performed on the related financial statement accounts and disclosures. While this could lead to an incremental improvement in audit and financial reporting quality for the identified critical audit matters, it is also possible that there may be increased costs for auditors as a result of the requirements. For example, even though the final standard does not mandate the performance of additional audit procedures other than with respect to communication of critical audit matters, it is possible that some auditors may perform additional procedures. If that occurs, the associated costs may be passed on—in whole, in part, or not at all—to companies and their investors in the form of higher audit fees. Further, increased procedures may also require additional time from the company's management to deal with such procedures. Some commenters suggested that the increased attention on certain matters could also lead to a related decrease in audit and financial reporting quality if other material aspects of the financial statements and disclosures receive less attention.

Some commenters argued that including critical audit matters in the auditor's report would impair the relationship between auditors and management or auditors and the audit committee. Other commenters suggested that the required reporting of critical audit matters would inhibit communication among the auditor, management, and the audit committee because of concerns about what would be publicly communicated in the auditor's report. One commenter also suggested that auditors may include additional matters in audit committee communications out of concern that an

<sup>143</sup> *Id.*

<sup>144</sup> The Board finds the UK experience instructive, although it is, of course, possible that differences between the UK and U.S. litigation and regulatory environments may influence the extent to which these findings would generalize to the U.S. market.

<sup>139</sup> See PCAOB Release No. 2016-003, section VI.D.2.a, footnote 169 and accompanying text.

<sup>140</sup> See PCAOB White Paper.

<sup>141</sup> See FRC 2016 Report.

<sup>142</sup> *Id.*



omission could lead to regulatory sanctions or liability. Other commenters have said that it would enhance communication among the participants in the financial reporting process.

An experimental study analyzed how the strength of audit committee oversight of the financial reporting process varied with the presence of sophisticated investors and knowledge of forthcoming expanded auditor reporting.<sup>145</sup> The author found that study participants, most of whom were experienced audit committee members, asked fewer probing questions if they knew that the auditor would be providing a discussion of the significant accounting estimate in the auditor's report. The author argued that by asking fewer probing questions audit committee members subconsciously insulated themselves from potential challenges mounted by investors regarding the appropriateness of the company's financial reporting. The Board is not aware of evidence this has occurred in the jurisdictions that have adopted expanded auditor reporting. Moreover, it may be difficult in an experimental setting to recreate the actual legal responsibility and potential liability that audit committee members face, which may limit the extent to which the experimental results would generalize to actual behavior in real-world settings.

Similarly, as described in the economic analysis of the reproposal and asserted by at least one commenter, management may have an incentive to withhold information from the auditor in order to prevent an issue from being described in the auditor's report. It seems unlikely, however, that management would or could withhold information from the auditor on the most critical issues in the audit because it could result in a scope limitation. On the contrary, it may be just as likely that management would communicate more information to the auditor as a means of demonstrating that an issue is not challenging, subjective, or complex, and, therefore, would not need to be described in the auditor's report.

Under the final standard, critical audit matters are determined from the matters communicated or required to be communicated to the audit committee. As noted earlier, with respect to any matters already required to be communicated to the audit committee, there should not be a chilling effect or

reduced communications to the audit committee. Therefore, it would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee, although, as previously described, given the breadth of current communication requirements, the Board believes there will likely be few communications affected by that possibility.

#### Potential Impact on Management Disclosure

Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management. While some commenters asserted that this would be beneficial, others claimed it would be an unintended negative consequence of requiring the communication of critical audit matters. Several commenters characterized this as inappropriately expanding the role of the auditor in the financial reporting process, while undermining the role of management and the audit committee. In their view, this would be especially problematic if the final standard permitted the auditor to communicate information that was not otherwise required to be disclosed (for example, because it did not meet a specified threshold for disclosure, such as a significant deficiency in internal control over financial reporting). Commenters claimed that auditor communication of this "original information" would cause a number of unintended consequences, including significant costs, disclosure of confidential or competitively sensitive information, and potentially misleading or incomplete information.

Investors and other commenters pointed out that, although expanded auditor reporting would give the auditor additional leverage over management's disclosure choices, this could result in improvements in the usability of financial statements and increases in financial reporting quality. One of these commenters cited academic research noting that, in current practice, disclosure is already guided by an iterative process between management and the auditor. This commenter reasoned that concerns regarding "original information" were misplaced because the iterative process would reduce the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.

Another commenter pointed out that auditors would not have incentives to interpret the Board's rule to require

disclosure of original information in most situations. For example, concerns about the limitations of their knowledge and expertise, potential liability implications, and friction in the relationship with the company are likely to discourage auditors from going beyond management disclosures. Nevertheless, the final standard contemplates that the auditor will do so only when it is necessary to describe the principal considerations that led the auditor to determine that a matter was especially challenging, subjective, or complex and how the matter was addressed in the audit. The Board believes that this provision is needed in order to ensure that the fact that management did not provide a disclosure would not prevent the auditor from communicating a critical audit matter.

Although the communication of critical audit matters may lead to changes in the incentives for the auditor, company management, and the audit committee to communicate with each other, initial anecdotal evidence from the Board's outreach activities suggests that the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications.

#### Changes in Perceived Assurance on the Auditor's Report, Including Perceptions of Auditor Liability

The communication of critical audit matters could have liability implications for auditors. In addition, because the communication of critical audit matters requires auditors to discuss aspects of the audit that they found to be especially challenging, subjective, or complex, it is possible that some investors and financial statement users may misconstrue the communications to mean that auditors were unable to obtain reasonable assurance about the matters identified as critical audit matters. Some commenters have said that the communication of critical audit matters could lead to changes in the way investors and financial statements users perceive the level of assurance provided by the auditor on matters identified as critical audit matters, including that it could undermine the basic pass/fail opinion. This could lead investors to erroneously conclude that there is a problem with the audit either in the areas identified in critical audit matters or other areas, or that auditors are providing separate assurance about the presentation of the financial statements, which may have implications for perceptions of auditor responsibility in the event of an audit failure.

<sup>145</sup> Yoon Ju Kang, *Are Audit Committees More Challenging Given a Sophisticated Investor Base? Does the Answer Change Given Anticipation of Additional Mandatory Audit Report Disclosure?* (working paper submitted as comment letter No. 17, available on the Board's Web site in Docket 034).

As discussed in the economic analysis of the reproposal, several academic papers analyze certain risks associated with communicating critical audit matters, including perception of auditor responsibility.<sup>146</sup> If the communication of critical audit matters were to lead to a reduction in perceived auditor responsibility, as is suggested by some academic research, and this in turn reduced auditor liability, it is possible that auditors may feel that less audit work is needed on the matters identified as critical audit matters, which could adversely affect audit quality (although the Board's other auditing standards, reinforced through firm quality control and Board inspections and enforcement activity, should provide a disincentive for auditors to decrease the amount or quality of audit work performed). It is difficult to draw generalizable conclusions based on the findings of these studies. In part, this is because their results vary and are sometimes contradictory, with some studies finding that expanded auditor reporting increases perceived auditor responsibility and others finding that it decreases perceived auditor responsibility. This may suggest that the results are sensitive to the experimental design and the context in which information is presented to study participants. In addition, it is not clear how the findings would correlate with changes in auditor behavior, because perceptions of auditor responsibility may be a poor proxy for actual auditor responsibility or liability.

To address the risk that the communication of critical audit matters could result in the perception of separate assurance, the final standard requires the following statement in the auditor's report:

The communication of critical audit matters does not alter in any way [the auditor's] opinion on the financial statements, taken as a whole, and [the auditor is not] by communicating the critical audit matters . . . providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

The purpose of this statement is to make clear that the communication of critical audit matters in an auditor's report should not be interpreted as altering the level of assurance on any aspect of the audit report, including the identified critical audit matters. In this regard, the Board also notes the view of some commenters that critical audit matters are likely to be used by institutional investors that are unlikely to misinterpret the information.

<sup>146</sup> See PCAOB Release No. 2016-003, Section V.I.D.2.d, footnotes 182-186 and accompanying text.

#### Auditor Tenure

Many commenters stated that information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about correlations between auditor tenure and/or independence and audit quality. Academic research on the relationship of tenure to audit quality has varied conclusions. For instance, some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.<sup>147</sup> Other academic research suggests that, at least prior to 2001, both short tenure (less than five years) and long tenure (greater than fifteen years) can have detrimental effects on audit quality.<sup>148</sup> Still other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality.<sup>149</sup>

The disclosure of auditor tenure is intended to add to the mix of information that investors can use. However, commenters other than investors did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors or could result in false conclusions about correlations between auditor tenure and audit quality or between auditor tenure and auditor independence. Many of these commenters recommended that, if the Board determined to require disclosure of auditor tenure, it should be disclosed in Form AP rather than in the auditor's report as a means of avoiding these inferences.

#### Alternatives Considered, Including Policy Choices Under the Final Standard

After considering the comments received, the Board is adopting a new

<sup>147</sup> See, e.g., Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 *Auditing: A Journal of Practice & Theory* 55, 55-69 (2004) and Timothy B. Bell, Monika Causholli, and W. Robert Knechel, *Audit Firm Tenure, Non-Audit Services, and Internal Assessments of Audit Quality*, 53 *Journal of Accounting Research* 461, 461-509 (2015).

<sup>148</sup> See, e.g., Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 *Contemporary Accounting Research* 517, 517-548 (2009).

<sup>149</sup> See, e.g., Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 *Accounting Horizons* 297, 297-314 (2008).

auditor reporting standard, AS 3101 and related amendments to its standards. The final standard retains the pass/fail model while expanding auditor reporting to include the communication of critical audit matters. Investor commenters have consistently asked for additional information in the auditor's report to make it more informative about the audit of the company's financial statements.

As described below, the Board has considered a number of alternative approaches to achieve the potential benefits of enhanced auditor reporting.

#### Alternatives Raised by Commenters

##### Only Cross-Reference to Management's Disclosures

Some commenters suggested that, instead of communicating critical audit matters as reproposed, auditors should only identify the critical audit matters and provide a cross-reference to management disclosures (*i.e.*, not describe the principal considerations that led the auditor to determine a matter is a critical audit matter or how it was addressed in the audit), or refer to or list critical accounting policies and estimates as disclosed by management. The Board believes that communicating the principal considerations that led the auditor to determine that a matter is a critical audit matter and how it was addressed in the audit will provide useful information beyond simply referencing existing management disclosure, and is more responsive to investor requests for more information from the auditor's perspective.

##### Auditor Association With Other Company Disclosures

Other commenters suggested more specific auditor assurance on particular management disclosures, such as inclusion of a statement in the auditor's report that the audit included evaluation of the accounting policies and significant estimates, with a cross-reference to management's disclosures, or a statement of auditor concurrence with the critical accounting policies and estimates of the company. One commenter suggested that audit committees should disclose critical audit matters with a corresponding confirmation from the independent auditor.

Several commenters on the proposal also suggested that the Board should consider auditor association with, or attestation on, portions of MD&A, specifically management's critical accounting policies and estimates, as an alternative to expanded auditor reporting. These commenters have

argued that such an association could increase the quality and reliability of the information subject to the procedures.

Some commenters on the concept release, including investors, said that they were not supportive of separate assurance by the auditor on information outside of the financial statements as an alternative to expanded auditor reporting, primarily because the related auditor reporting would have appeared in a standardized form and would not provide audit-specific information. Requiring such reporting might necessitate action by the SEC, as well as the PCAOB, to implement, including new SEC rules regarding management reporting and auditor attestation. In addition to reporting requirements, the PCAOB might have to develop new performance requirements and auditors would be required to undertake additional audit work in order to provide attestation in these areas.

Based on concerns about the complexity of such an approach, as well as the comments received as to its limited benefits, the Board determined not to pursue auditor association with portions of MD&A as an alternative to expanded auditor reporting at this time. The Board believes that this approach would fail to deliver the audit-specific information requested by investors, while also raising potential concerns about separate assurance on the identified matters.

#### No Change to Auditor Reporting Requirements

The Board considered whether changes to the existing auditor reporting requirements were needed. Auditor reporting under the current model has been criticized by many commenters as providing limited information. Auditors have not voluntarily provided more information in the auditor's report in response to investors' requests. A number of factors described above, such as potential costs and uncertainties related to voluntary auditor reporting and the potential for auditor status quo bias, may explain why voluntary reporting would not be expected to become prevalent. These factors suggest that voluntary reporting, with or without guidance to encourage it, could also create uncertainty about the content of auditor's reports because auditors would be able to choose whether to provide information about the audit, what information to provide, and the form in which to provide it. On that basis, the Board believes that standard setting is appropriate.

#### Consideration of Analogous Requirements of Other Regulators and Standard Setters

In developing the final standard, the Board took into account the requirements for expanded auditor reporting of other regulators and standard setters, such as the IAASB, the FRC, and the EU. Changes to the auditor's report that other regulators and standard setters have adopted include some commonality, such as communicating information about audit-specific matters in the auditor's report. Several commenters suggested that the Board align its requirements for expanded auditor reporting more closely with the requirements of the IAASB to provide more consistent global auditor reporting requirements.

However, the Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Because the Board's standards have the force of law, the Board aims to make them as clear and easy to apply as it can. For example, the factors that the auditor considers in determining whether a matter involved especially challenging, subjective, or complex auditor judgment are included in the standard; by contrast, while the IAASB approach includes similar factors, they appear in the application and other explanatory material.

In addition, there are differences between requirements and terminology of the Board's auditing standards and those of other regulators and standard setters that may cause inconsistent application, even if the Board were to adopt the approach of another standard setter. For example, the Board's requirements for communications to the audit committee are not identical to the analogous requirements of the IAASB. Therefore, although both critical audit matters and the IAASB's key audit matters are derived from such communications, the matters ultimately discussed with the audit committee under each framework would not necessarily be the same, which could result in differences in which matters are reported even if the language in the auditor reporting standards were identical. Also, the component of the definition of critical audit matter in the final standard, namely "matters that involve especially challenging, subjective, or complex auditor judgment" grounds the definition in the auditor's expertise and judgment. 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.

#### Auditor Assessment and Descriptions of Certain Financial Statement Areas

Several commenters on the concept release suggested that investors would be most interested in auditor reporting on the categories of information identified by investor respondents to the 2011 survey conducted by a working group of the IAG: (1) Significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them; (2) areas of high financial statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.<sup>150</sup> This request was reiterated by several commenters on the proposal, who continued to believe that this approach would provide the information investors want most. In a similar vein, other commenters on the reproposal have requested that the auditor provide a "grade" on management's significant accounting estimates and judgments.

The Board believes that the final critical audit matter definition will likely cover many of the topic areas requested by investors. For example, the auditor may communicate critical audit matters related to significant management estimates and judgments, highlight areas of high financial statement and audit risk, and discuss significant unusual transactions. However, the auditor will not be required to report on its assessment of management's significant estimates and judgments or on the quality (as opposed to merely the acceptability), of the company's accounting practices and policies or of the financial statements as a whole.

The final standard seeks to strike an appropriate balance between the value of the information being provided and the costs of providing it. Requiring auditors to report their qualitative assessments in a manner that appears very precise (for example, describing an estimate as "conservative" or "aggressive" or assigning the financial statements an "A" or a "B") may impose significantly greater costs and unintended consequences than the

<sup>150</sup> See IAG 2011 survey.

principles-based reporting of critical audit matters. For example, although the reporting of qualitative assessments would appear to be precise, these qualitative assessments are likely to be applied inconsistently because there is no framework for such assessments and the determinations are inherently subjective. In addition, such assessments may heighten concerns related to the perceived level of assurance provided by the audit or the perception that separate assurance is being provided as to the assessed areas. Also, the reporting of such qualitative assessments may subject auditors and companies to additional litigation risk beyond what may result from the principles-based reporting of critical audit matters because the apparent precision of the reporting may facilitate plaintiffs' claims.

#### Policy Choices

##### Definition of Critical Audit Matters

The Board considered a variety of possible approaches to the definition of critical audit matters suggested by commenters. *See above* for a discussion of the Board's considerations of the final standard.

##### Communication of Critical Audit Matters

The Board considered a variety of possible approaches to the communication requirements for critical audit matters. *See above* for a discussion of the Board's considerations of the final standard.

##### Auditor Tenure

The final standard retains the repropoed requirement to include a statement in the auditor's report about auditor tenure.

In the reproposal, the Board solicited comment on whether disclosure of auditor tenure should be made on Form AP instead of in the auditor's report. Form AP was developed as a means to address commenter concerns about the potential liability implications of naming persons in the auditor's report. Because the disclosure of auditor tenure does not have the same potential liability consequences, such an approach is unnecessary in this case. In addition, some commenters preferred tenure disclosure on Form AP because of a concern that disclosure in the auditor's report could result in inappropriate inferences about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. The Board is not persuaded by such concerns. Further, the final standard allows the auditor flexibility in the location of the

auditor tenure disclosure in the auditor's report.

The Board determined that disclosure will be better achieved through the auditor's report because the information will be more readily accessible upon the filing with the SEC of a document containing audited financial statements and poses lower search costs, particularly for those investors who may prefer to have the information provided in the auditor's primary means of communication. In addition, disclosing tenure in the auditor's report will make information available earlier to investors, which may assist in their voting on auditor ratification. However, disclosing auditor tenure in the auditor's report rather than Form AP could result in higher costs to investors that wish to accumulate tenure data for a large number of companies or compare data across companies because these investors will have to acquire tenure data from each company's auditor's report separately or from a data aggregator.

##### Additional Improvements to the Auditor's Report

The final standard includes a number of requirements that will enhance the standardized content of the auditor's report by clarifying the auditor's role and responsibilities related to the audit of the financial statements. These include, for example, statements regarding auditor independence requirements and the addition of 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. In addition, the final standard includes requirements intended to promote uniformity in the form of the auditor's report. These include requirements as to the addressee, a specific order of certain sections of the auditor's report, and required section headings.

Many commenters generally supported these enhancements and suggested that such enhancements will increase the usability of the auditor's report by improving financial statement users' understanding of the auditor's responsibilities, reducing search costs for information in the auditor's report, and facilitating comparisons across auditor's reports.

##### Applicability of Critical Audit Matter Requirements

##### Brokers and Dealers, Investment Companies, and Benefit Plans

The repropoed standard did not require communication of critical audit matters for audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than business development companies ("BDCs"), and benefit plans. The repropoed release described the Board's rationale, including economic considerations, for such exclusions from the critical audit matter requirements and noted that auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

Commenters generally supported these exclusions, pointing to the same or similar reasons to those described by the Board in the repropoed release. Some commenters asserted that the communication of critical audit matters should apply to all companies. One commenter supported voluntary communication of critical audit matters for the exempted entities. Another commenter disagreed with providing auditors the ability to voluntarily communicate critical audit matters for brokers and dealers and investment companies. This commenter also suggested that all broker-dealers, including broker-dealers that are issuers, should be excluded from the requirement.

After considering the comments received and evaluating benefits and costs, the final standard excludes the audits of brokers and dealers that are reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans, from the critical audit matter requirements as repropoed.<sup>151</sup> Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily.

The Board's rationales for these exclusions are described below.

##### Brokers and Dealers Reporting Under Exchange Act Rule 17a-5

Pursuant to Exchange Act Rule 17a-5, the annual reports that brokers and dealers file with the SEC are public, except that if the statement of financial condition in the financial report is bound separately from the balance of the annual report, the balance of the annual report is deemed confidential and nonpublic.<sup>152</sup> In this situation, the

<sup>151</sup> The other requirements of the final standard will be applicable to audits of these entities.

<sup>152</sup> *See* Exchange Act Rule 17a-5(e), 17 CFR 240.17a-5(e).

auditor would generally issue two separate auditor's reports that would have different content: (1) An auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete financial report that, except as provided in paragraph (c)(2)(iv) of Exchange Act Rule 17a-5, would be confidential and not available to the public.<sup>153</sup> Research by the PCAOB's Office of Economic and Risk Analysis ("ERA")<sup>154</sup> indicates that, for approximately half of brokers and dealers, the complete financial report and the related auditor's report are confidential and not available to the public.

In 2013, the Board adopted new standards related to brokers and dealers that enhanced the auditor's performance and reporting responsibilities for financial statement audits, as well as engagements on compliance and exemption reports of brokers and dealers.<sup>155</sup>

Some commenters on the proposal asserted that the value of reporting critical audit matters for brokers and dealers would be significantly limited by the closely held nature of brokers and dealers; the limited number of users of their financial statements; and the fact that, in many cases, only the statement of financial condition is available publicly. Some commenters also recognized that both the SEC and PCAOB recently updated their rules to further enhance reporting by brokers and dealers and their auditors.

Research by ERA indicates that currently there are no brokers or dealers that are issuers. Rather, brokers and dealers are often owned by a holding company, an individual, or a group of individuals that holds a controlling interest. The owners of brokers and dealers are generally part of the management of the entity and therefore would have direct access to the auditor. Given that, in many cases, there is much less separation of ownership and control

in brokers and dealers than in issuers, the communication of critical audit matters would provide little information about the audit that would otherwise be unobtainable by investors.

Although there may be circumstances in which other financial statement users may benefit from reduced information asymmetry about the audits of brokers and dealers, certain aspects of broker and dealer financial reporting may limit the benefits of requiring the communication of critical audit matters. For example, while other financial statement users, such as customers of brokers and dealers, may benefit from increased information about the audit, the ability for brokers and dealers to file certain financial statements and schedules confidentially would require the auditor to identify and communicate critical audit matters that apply only to the publicly available statement of financial condition. This may reduce the value of communicating critical audit matters for brokers and dealers relative to issuers. Moreover, customers of brokers and dealers may be interested in the overall financial position of the broker or dealer but may not benefit from audit-specific information in the same way as investors in an issuer.

The communication of critical audit matters may also impose additional costs on the auditors of brokers and dealers relative to the auditors of other types of companies, as they would have to identify critical audit matters that apply exclusively to the publicly available financial information, which may be difficult in some situations.

After consideration of the ownership and reporting characteristics of brokers and dealers, the comments received on the proposal and reproposal, and the Board's recent standard-setting activities related to brokers and dealers, the Board does not believe that reporting of critical audit matters for brokers and dealers will provide meaningful information in the same way as for issuers. Therefore, the communication of critical audit matters is not required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5. If a broker or dealer were an issuer required to file audited financial statements under Section 13 or 15(d) of the Exchange Act, the requirements would apply.

#### Investment Companies

The Investment Company Act generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in

securities.<sup>156</sup> Most investment companies registered under the Investment Company Act are required to file with the SEC annual reports on Form N-CSR containing audited financial statements.<sup>157</sup> The Investment Company Act includes specific requirements for investment companies, intended to reduce investors' risks, in areas such as an investment company's portfolio diversification, liquidity, leverage, and custody of securities.<sup>158</sup>

In an SEC rulemaking, the SEC observed that commenters believed the key information that investors use in deciding to invest in an investment company includes an investment company's investment objectives, strategies, risks, costs, and performance.<sup>159</sup> The disclosure of information about these items appears in the annual prospectus that investment companies provide to current and future investors.<sup>160</sup> Changes to investment objectives and strategies require shareholder approval or disclosure.<sup>161</sup>

Several commenters on the proposal noted that an investor's decision to invest in an investment company is primarily based on the investment objectives, risks, performance, and fees, and critical audit matters are not expected to provide information about these items and therefore would not be relevant. These and other commenters generally stated that investment companies are designed for the sole purpose of trading in and holding investments and auditor judgment would arise primarily with respect to valuation of investments, which would tend to be repeated as a critical audit matter. One of these commenters noted that, since the strategies of investment companies do not change significantly over time, the critical audit matters identified could become standardized from one reporting period to the next and also across funds with similar objectives.

Even though the disclosures required under the Investment Company Act and

<sup>156</sup> See Section 3(a)(1) of the Investment Company Act.

<sup>157</sup> See SEC Rules under Section 30(e) of the Investment Company Act.

<sup>158</sup> See, e.g., Sections 12, 13, and 17 of the Investment Company Act.

<sup>159</sup> See SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 8998, 74 FR 4546 (Jan. 26, 2009). See also Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006) at 2-3.

<sup>160</sup> See SEC Rules under Section 30(e) of the Investment Company Act.

<sup>161</sup> See Sections 8(b) and 13(a)(3) of the Investment Company Act and Investment Company Act Rule 8b-16.

<sup>153</sup> See also Exchange Act Rule 17a-5(c)(2), 17 CFR 240.17a-5(c)(2), regarding audited statements required to be provided to customers.

<sup>154</sup> ERA's research was conducted on brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014 that included audit reports issued by firms registered with the PCAOB.

<sup>155</sup> See *Attestation Standards for Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-007 (Oct. 10, 2013) and *Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

other federal securities laws provide investors with useful information, they may not fully substitute for the communication of critical audit matters. The required communication of critical audit matters contemplates that auditors would provide investors with audit-specific information, which is unlikely to appear in the disclosures provided by management. In addition, some academic research documented a difference in the perceived usefulness and reliability of information depending on the location of the disclosure and whether it was disclosed by management or by the independent auditor.<sup>162</sup> This academic research suggests that the auditor's communication of information similar to critical audit matters may provide value to investors because it comes from the auditor, even if the same information is disclosed by management in the experimental design of the study.

The benefits of providing critical audit matters, however, may be smaller for investment companies, other than BDCs, relative to other types of companies because of their purpose and structure. Unlike companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. This creates the potential for critical audit matters of investment companies to become excessively repetitive, making them uninformative.

There may also be additional costs of applying critical audit matter requirements to audits of investment companies, other than BDCs, as compared to audits of other types of companies. For example, in some cases, annual shareholder reports of affiliated investment companies with the same fiscal year-end might be filed with the SEC in one document, which generally contains a single auditor's report that covers multiple audited investment companies. In these situations, communicating critical audit matters specific to each investment company may require the auditor to prepare separate auditor's reports. This could increase costs for these types of investment companies.

After consideration of the purpose and reporting characteristics of investment companies and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of most investment companies, although they

will apply to audits of investment companies regulated as BDCs.<sup>163</sup> Unlike the audits of many other investment companies, auditing the valuation of BDCs' investments generally involves complexity and auditor judgments due to the nature of the BDCs' portfolios. Also, because of the more diverse operations of BDCs, such as providing managerial assistance and involvement with more complex debt and equity instruments than other investment companies, communication of critical audit matters in a BDC audit could be more informative to investors. Additionally, BDCs follow a reporting regime under the Exchange Act that is more closely aligned with that of companies to which the Board is applying the requirements for critical audit matters. For these reasons, the Board believes it is appropriate for audits of BDCs to be subject to critical audit matter requirements.

#### Benefit Plans

Benefit plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K<sup>164</sup> that includes the benefit plan's audited financial statements and the related auditor's report.<sup>165</sup> The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.<sup>166</sup>

Participation in a benefit plan is limited to eligible employees of the plan sponsor. Each plan participant in a defined contribution benefit plan is responsible for selecting, from the investment options made available by the plan sponsor, the specific investments in which the participant's funds are invested.

Employee stock benefit plans are generally less complex than other types

of companies because they are designed for the sole purpose of holding the plan's investments for the participants' benefit. A plan's financial statements reflect summary information about the plan's assets and liabilities by aggregating the balances of all plan participants. However, only the individual account statements that plan participants receive periodically provide information specific to each participant's investments.

Several commenters on the proposal suggested excluding audits of benefit plans from the requirement for reporting critical audit matters due to the unique characteristics of these entities and their differences from other types of companies. For example, some commenters indicated that benefit plans are designed for a specific purpose and, as a result, would likely have similar critical audit matters from one reporting period to the next. Other commenters noted that benefit plans are inherently less complex and entail fewer estimates and judgments.

The communication of critical audit matters could provide information about any complex issues that were identified during the audit and how the auditor addressed them. However, since a benefit plan's assets and liabilities aggregate the balances of all plan participants, the financial statements or related critical audit matters would not provide actionable information about a plan participant's specific investment. Further, given the nature of benefit plans, there is a chance that the same critical audit matters would be communicated each year. For example, the valuation of investments is likely to be the most complex area in the audit of a benefit plan and therefore may be a critical audit matter in each reporting period, making the information less useful.

After consideration of the structure and reporting characteristics of benefit plans and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of benefit plans.

#### Smaller Companies

The reproposal sought comment on whether the critical audit matter requirements should not apply to audits of other types of companies, in addition to the exempted entities discussed above. Some commenters asserted that the communication of critical audit matters should apply to all companies. Other commenters recommended that the Board give consideration to not applying the critical audit matter requirements to audits of smaller

<sup>162</sup> See, e.g., Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

<sup>163</sup> See Section 54 of the Investment Company Act.

<sup>164</sup> See Section 15(d) of the Exchange Act.

<sup>165</sup> A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. See Exchange Act Rule 15d-21, CFR 240.15d-21.

<sup>166</sup> ERISA Section 103(a)(3)(A) requires a plan administrator to engage an independent auditor to conduct an examination of the plan's financial statements and required schedules in accordance with generally accepted auditing standards. See 29 CFR 2520.103-1. Benefit plans subject to ERISA also file with the DOL an annual report on Form 5500, including audited financial statements and an auditor's report. See also FASB ASC 960-10-05-6.

reporting companies<sup>167</sup> and nonaccelerated filers<sup>168</sup> due to their smaller size and because, in the commenters' view, communication of critical audit matters would not provide sufficient benefits for these companies to justify the costs.

Academic research suggests that smaller companies have a higher degree of information asymmetry relative to the broader population of companies. Although the degree of information asymmetry surrounding a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.<sup>169</sup> To the extent that a smaller company can be characterized as exhibiting one or more of these properties, this may suggest that it has a greater degree of information asymmetry relative to the broader population of companies. This would suggest that there is a higher likelihood that critical audit matters could provide new information about a smaller company than a large one for which there already exists a variety of information sources (such as annual reports, news media, and analyst research reports).

After consideration of comments, academic research, and data regarding the number of such companies, the final standard does not exclude smaller companies from the critical audit matter requirements. However, as discussed

<sup>167</sup> In general, a "smaller reporting company" means an issuer with less than \$75 million in public float or zero public float and annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. See Exchange Act Rule 12b-2, 17 CFR 240.12b-2. Smaller reporting companies currently make up approximately 42 percent of Form 10-K filers. The SEC recently proposed changes to the definition of smaller reporting companies, which would increase the percentage of smaller reporting companies to approximately 52 percent of Form 10-K filers. See SEC, *Amendments to Smaller Reporting Company Definition*, Release No. 33-10107 (June 27, 2016), 81 FR 43130 (July 1, 2016).

<sup>168</sup> Nonaccelerated filers are not defined in SEC rules but are generally understood to be companies that do not meet the definition of large accelerated filer or accelerated filer.

<sup>169</sup> See, e.g., David Aboody, and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 *The Journal of Finance* 2747, 2747-2766 (2000), Michael J. Brennan and Avaniidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361, 361-381 (1995), Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics* 101, 101-121 (1988), and Raymond Chiang, and P.C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A note*, 43 *The Journal of Finance* 1041, 1041-1048 (1988).

below, the Board has determined that it is appropriate to give auditors of smaller companies additional time to implement the new requirements. If approved by the SEC, auditors of companies that are not large accelerated filers will have an additional 18 months to implement the requirements for critical audit matters and will be able to benefit from the experiences of auditors of larger companies.

#### Requirements of Other Regulators and Standard Setters

Under the IAASB's standard, the communication of key audit matters applies to listed entities.<sup>170</sup> The EU requirements apply to audits of PIEs, including listed companies, credit institutions, and insurance companies.<sup>171</sup> The FRC 2013 requirements apply to auditor's reports for entities that apply the UK Corporate Governance Code.<sup>172</sup>

#### Considerations for Audits of Emerging Growth Companies

Section 104 of the Jumpstart Our Business Startups ("JOBS") Act imposes certain limitations with respect to application of the Board's standards to audits of EGCs, as defined in Section 3(a)(80) of the Exchange Act. Section 104 provides that "[a]ny rules of the Board requiring . . . a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company . . ." <sup>173</sup> Auditor discussion and analysis ("AD&A") does not exist in auditing standards. The idea was introduced in the concept release, which described AD&A as one of several conceptual alternatives for changing the auditor's reporting model.<sup>174</sup>

Section 104 of the JOBS Act further provides that any additional rules adopted by the Board subsequent to

<sup>170</sup> See paragraph 5 of ISA 701.

<sup>171</sup> See requirements in 1 of Article 2, Audit Report of Regulation (EU) No 537/2014.

<sup>172</sup> These 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.

<sup>173</sup> See Public Law 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act.

<sup>174</sup> See PCAOB Release No. 2011-003 (June 21, 2011) at 2 (describing one alternative as "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements (an 'Auditor's Discussion and Analysis')"). Section IV.A., Auditor's Discussion and Analysis, of the proposal further described AD&A and related comments received on the concept release.

April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."<sup>175</sup> As a result of the JOBS Act, the final standard and amendments are subject to an evaluation as to whether they could, and if so, should be applicable to the audits of EGCs.

#### Critical Audit Matters

The reproposal solicited comment on the application of critical audit matter requirements to the audits of EGCs. Commenters on this issue generally favored applying the standard to audits of EGCs, primarily because investors in these companies would benefit from the additional information communicated in the auditor's report in the same way that investors in larger companies would. Two commenters recommended that the critical audit matter requirements not apply to audits of EGCs because there would not be sufficient benefits to justify the costs.

Three commenters addressed the legal question of whether the JOBS Act provision on AD&A would prohibit the Board from applying critical audit matter requirements to audits of EGCs. Two of these commenters suggested that this would be prohibited, on the basis that critical audit matters "appear substantively similar to" <sup>176</sup> or "closely resemble" <sup>177</sup> AD&A. The SEC's Investor Advocate stated that, from a policy perspective, critical audit matter requirements should apply to audits of EGCs, and recommended that the PCAOB adopt the standard for policy reasons and let the SEC determine the legal question.<sup>178</sup> This commenter also recommended that, "to prepare for any outcome of the SEC's determination," the PCAOB should encourage auditors, on a voluntary basis, to include critical audit matter communications in the auditor's reports on EGCs."<sup>179</sup>

The requirements for critical audit matters share characteristics with two of

<sup>175</sup> See Section 103(a)(3)(C) of Sarbanes-Oxley.

<sup>176</sup> See letter from the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Aug. 15, 2016) at 10, available on the Board's Web site in Docket 034.

<sup>177</sup> See letter from Robert N. Waxman (Aug. 15, 2016) at 24, available on the Board's Web site in Docket 034.

<sup>178</sup> See letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 5-6, available on the Board's Web site in Docket 034 (noting that "the SEC will need to make a legal determination on whether such a requirement with respect to the audits of EGCs would accord with certain provisions of" the JOBS Act).

<sup>179</sup> 179 Id. at 6.



the alternative approaches described in the concept release: Required and expanded explanatory paragraphs and AD&A. Similar to critical audit matters, required and expanded explanatory paragraphs involved additional paragraphs in the auditor's report that would have highlighted areas of critical importance to the financial statements, with auditor comment on key audit procedures and a reference to relevant financial statement accounts and disclosure. AD&A, by contrast, envisioned a supplemental report in addition to the auditor's report that could cover a broad range of issues, including the auditor's views regarding the company's financial statements, material matters as to which the auditor believed disclosure could be enhanced, and areas where management could have applied different accounting or disclosure approaches.

However, critical audit matters go beyond the content of a required and expanded explanatory paragraph by including a discussion of the principal reasons the auditor determined that a matter was a critical audit matter. Further, although this is not required, critical audit matters could potentially include a discussion of auditor findings. These additional elements may make critical audit matters resemble AD&A in some respects. This potential similarity, together with the fact that there has been no authoritative interpretation of Section 104 of the JOBS Act, creates some uncertainty as to whether it is legally permissible for critical audit matter requirements to be mandated for EGC audits. In view of this uncertainty, the Board has determined not to apply the requirements regarding critical audit matters to audits of EGCs at this time.

As with other audits where critical audit matter requirements do not apply, voluntary application is permissible. EGCs and their auditors can consider whether investors would benefit from additional information about the audit from the auditor's point of view.

#### Additional Improvements to the Auditor's Report

The additional improvements to the auditor's report contained in the final standard and amendments do not raise concerns under the AD&A provisions of the JOBS Act, but instead fall within the category of "additional rules" that may not be applied to audits of EGCs unless the SEC determines that doing so "is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." The Board is

providing this analysis to assist the SEC in making this determination.

To inform consideration of the application of auditing standards to audits of EGCs, the staff has also published a white paper that provides general information about characteristics of EGCs.<sup>180</sup> The data on EGCs outlined in the white paper remains generally consistent with the data discussed in the reproposal. A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.<sup>181</sup>

The reproposal solicited comment on whether the elements of the reproposed standard and amendments other than the requirements for critical audit matters should apply to the audits of EGCs. As noted above, one commenter supported application of the entire standard and amendments to EGCs (without differentiating between critical audit matters and other elements), and one commenter opposed application of the entire standard and amendments. In addition, one commenter supported applying some of the reproposed improvements to the auditor's report to audits of EGCs (the requirement as to addressee and the clarifications of existing auditor responsibilities, as well as a modified version of the statement regarding auditor independence), but generally opposed the other aspects of the reproposal for both EGCs and other companies.

As described above, the additional improvements to the auditor's report are intended to provide a consistent location and decrease search costs with respect to information about auditor tenure, enhance users' understanding of the auditor's role, make the auditor's report easier to read and facilitate comparison across companies by making the format consistent. As

<sup>180</sup> See *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the Board's Web site in Docket 034.

<sup>181</sup> See SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (Apr. 23, 2006) at 73.

described above, the costs associated with these changes are not expected to be significant and are primarily one-time, rather than recurring, costs.

For the reasons explained above, the Board believes that the additional improvements to the auditor's report contained in the final standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the final standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the SEC determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the final standard and amendments, other than the provisions relating to critical audit matters, to audits of EGCs. The Board stands ready to assist the SEC in considering any comments the SEC receives on these matters during the SEC's public comment process.

### III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Pursuant to Section 19(b)(2)(A)(ii) of the Exchange Act, and based on its determination that an extension of the period set forth in Section 19(b)(2)(A)(i) of the Exchange Act is appropriate in light of the PCAOB's request that the Commission, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, determine that the proposed rules, other than the provisions relating to critical audit matters, apply to audits of emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act, the Commission has determined to extend to October 26, 2017 the date by which the Commission should take action on the proposed rules.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number PCAOB-2017-01 on the subject line.

*Paper Comments*

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2017-01. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements

with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without charge; we do not edit personal

identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2017-01 and should be submitted on or before August 18, 2017.

For the Commission, by the Office of the Chief Accountant, by delegated authority.<sup>182</sup>

**Eduardo A. Aleman,**

*Assistant Secretary.*

[FR Doc. 2017-15718 Filed 7-27-17; 8:45 am]

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<sup>182</sup> 17 CFR 200.30-11(b)(1) and (3).