

# Defining Issues<sup>®</sup>

## PCAOB issues auditing standard to enhance auditor's report

June 22, 2017

KPMG reports on a new PCAOB auditing standard<sup>1</sup>, which will significantly affect the auditor's report.

### Applicability

The new PCAOB standard and related amendments (collectively referred to as the new standard) applies to audits conducted under PCAOB standards with certain exceptions.

The requirements related to **critical audit matters** (CAMs) do not apply to audits of (1) brokers and dealers reporting under Exchange Act Rule 17a-5; (2) investment companies except for business development companies; (3) employee stock purchase, savings and similar plans; or (4) emerging growth companies.

### Key facts and impacts

The new standard, which retains the pass/fail model of the existing auditor's report, represents the most meaningful change to the auditor's report since the 1940s. The PCAOB believes the new standard will enhance the auditor's reporting model by:

- requiring the auditor to communicate CAMs that were addressed during the audit of the current period's financial statements, or to determine and state that there were no CAMs;
- adding new elements related to the auditor's independence and tenure;
- enhancing certain standardized language; and

- standardizing the form of the auditor's report by moving the opinion paragraph to the first paragraph of the report, and requiring section titles to help guide the reader.

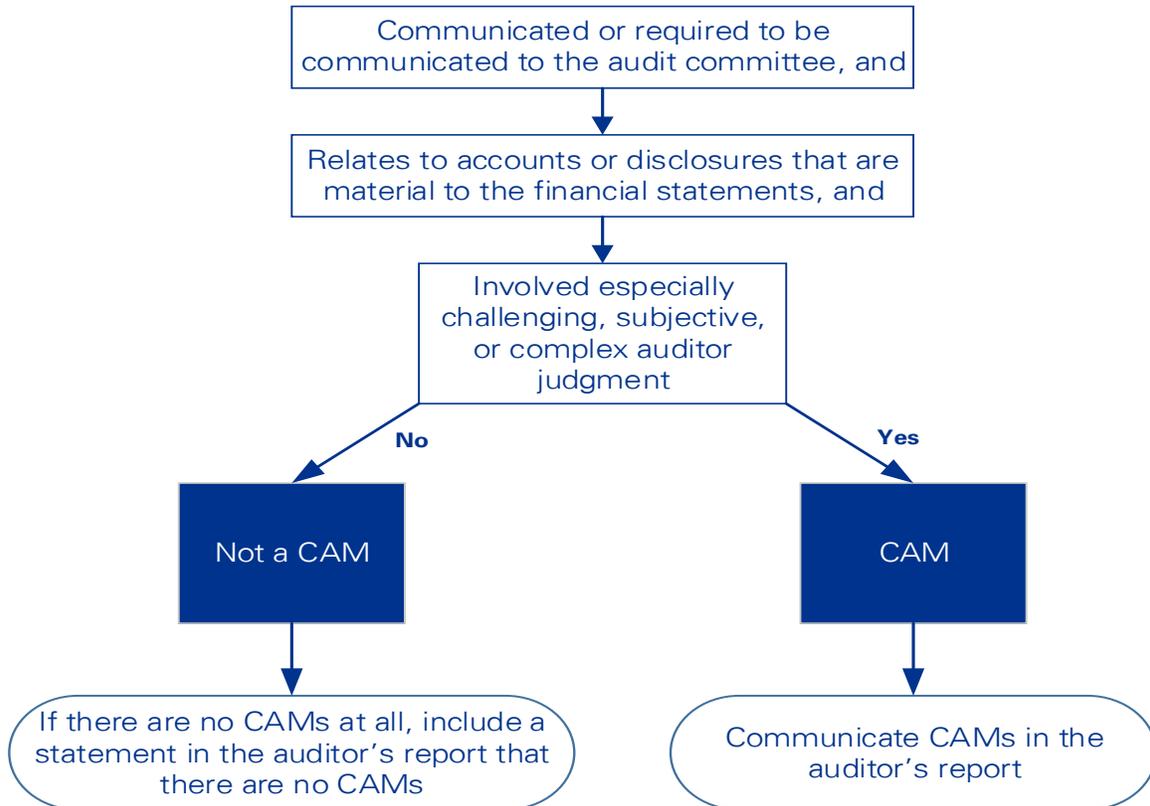
### Critical audit matters

CAMs are those matters arising from the financial statement audit that were communicated or required to be communicated to the audit committee that (1) relate to accounts or disclosures material to the financial statements and (2) involve especially challenging, subjective or complex auditor judgment.

The requirement to communicate CAMs is intended to improve the relevance of the auditor's report by providing more insight about the most significant matters that the auditor addressed in the audit. This communication is based on information known to the auditor and procedures already performed as part of the audit. However, the new standard imposes incremental audit performance requirements about determining, communicating and documenting CAMs. In the unusual situation in which the auditor determines that there were no CAMs, the auditor must state that fact. The *Critical Audit Matters* section of the auditor's report will follow the *Basis for Opinion* section.

<sup>1</sup> PCAOB Release No. 2017-001, [The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards](#) (flowchart reproduced from the PCAOB Release)

## Determining and communicating CAMs



### Factors to consider in determining whether a matter is a CAM

Factors for the auditor to consider in determining whether a matter is a CAM include the:

- auditor's assessment of the risks of material misstatement, including significant risks;
- degree of auditor judgment related to areas in the financial statements that involved significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- degree of auditor subjectivity involved in applying audit procedures to address the matter or in evaluating their results;
- 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 about the matter; and
- nature and audit evidence obtained about the matter.

### Items to communicate for each CAM

For each CAM communicated in the auditor's report, the auditor is required to:

- identify the CAM;
- describe the principal considerations that led the auditor to determine that the matter is a CAM;
- describe how the auditor addressed the CAM in the audit; and
- refer to the relevant financial statement accounts or disclosures that relate to the CAM.

### KPMG observation

The requirement for the auditor's report to communicate CAMs will be of significant interest to senior management and members of the audit committee. An amendment to AS 1301<sup>2</sup> will require auditors to provide a draft of the auditor's report to, and discuss it with, the audit committee. In most situations, the auditor should be able to draft substantial portions of the CAMs section of the auditor's report well in advance of the completion of the audit.

### Elements of the auditor's report

The new standard retains the basic elements of the auditor's report from existing auditor reporting standards. It adds new elements to provide investors and other financial statement users with information about the auditor including:

- auditor independence – a statement about the auditor's requirement to be independent with respect to the company; and
- auditor tenure – the first year in which the auditor began consecutive service as the company's auditor.

### KPMG observation

The PCAOB acknowledged that academic research about the correlation between auditor tenure and audit quality is inconclusive. However, the PCAOB ultimately decided to require the disclosure of tenure in the auditor's report, rather than in Form AP<sup>3</sup>, because the PCAOB believes the information will be more readily accessible to investors in the auditor's report, which will lower search costs. Many larger companies are already voluntarily disclosing auditor tenure in their proxy statement, so such information in the auditor's report will not be new information to investors in those companies.

### Enhanced standard language

The standardized language in the auditor's report requires the phrase 'whether due to error or fraud', when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether a

company's financial statements are free of material misstatements. The phrase 'and the related notes' is added to the opinion paragraph of the auditor's report to clarify that the financial statements include the notes to the financial statements.

### KPMG observation

The enhanced standard language is meant to clarify items for the benefit of users of the financial statements. It does not create incremental requirements for the auditor.

### Standardizing the form of the auditor's report

The opinion paragraph will be the first paragraph of the auditor's report, preceded by the section title *Opinion on the Financial Statements*. The second section of the report will use the section title *Basis for Opinion*. Section titles will also be used if other paragraphs are included in the

auditor's report – e.g. if an emphasis of matter paragraph is added.

If the auditor did not perform an integrated audit, but management is required to report on the company's internal control over financial reporting, the auditor's report will be required to explicitly state that the auditor is required to obtain an understanding of the company's

<sup>2</sup> AS 1301, [Communications with Audit Committees](#)

<sup>3</sup> Form AP, [Auditor Reporting of Certain Audit Participants](#), is required to be filed by auditors with the PCAOB, and it includes the name of the signing partner and information about other firms participating in the audit

internal control over financial reporting, but not for the purpose of expressing an opinion on its effectiveness, and that the auditor expresses no opinion about internal control over financial

reporting. In addition, the auditor’s report will now be addressed to the company’s shareholders and its board of directors (or equivalents).

### KPMG observation

Reordering of the paragraphs in the auditor’s report, and using section titles to help guide the reader of the report, will make the auditor’s report for an audit conducted under PCAOB standards generally consistent with the form of an auditor’s report for an audit conducted under International Standards on Auditing.<sup>4</sup>

### Background

The new standard is the result of a long, deliberative process, which included a concept release in June 2011, a proposed standard in August 2013, and a reproposal of the auditor reporting standard in May 2016.<sup>5</sup> Before issuing the new standard, the PCAOB considered comments received on the three documents, input from various constituencies at a public meeting in April 2014, and discussion of the proposal and reproposal at meetings of the PCAOB’s Standing Advisory Group and Investor Advisory Group.

### Effective dates

	CAM requirements		All other requirements
	Large accelerated filers	All other filers	
Fiscal years ending after	June 30, 2019	December 15, 2020	December 15, 2017
Early application allowed?	Auditors may apply the new standard before the effective dates once the SEC has approved the new standard.		

<sup>4</sup> International Standard on Auditing No. 700 (Revised), [Forming an Opinion and Reporting on Financial Statements](#)

<sup>5</sup> PCAOB Release No. 2011-003, [Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards](#); PCAOB Release No. 2013-005, [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](#); and PCAOB Release No. 2016-003, [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](#)

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