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LEGAL BRIEFING: SECURITIES LAW
NEW PCAOB AUDITOR REPORTING STANDARD

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SEC Adopts New PCAOB Auditor Reporting Standard Mandating Disclosure of 'critical audit matters'

On October 23, the Commissioner of the Securities and Exchange Commission (SEC), Kara M. Stein, issued a [public statement](#) where it was announced that all three SEC Commissioners voted unanimously to support and adopt Auditing Standard (AS) 3101 ('The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion'). Through a [concept release](#), this standard was earlier proposed by the Public Company Accounting Oversight Board (PCAOB)- an independent body that regulates auditing practice. The Commissioner highlighted that the approval is the first significant development in the audit reporting area in more than 70 years.

The approval of the standard comes in the wake of demands for increased investor protection by way of improved disclosures. In response to the concept releases issued by PCAOB soliciting public comment in this area, it received several investors' comments, predominantly complaining that there was a lack of information about the rationale behind auditor's decisions or opinions.

The standard requires auditors of public companies to provide investors with a more informative audit report. As per the SEC Commissioner, this information mainly relates to "*significant estimates and judgements, significant unusual transactions and other areas of risk*". Auditors will now be required to provide investors with information on critical audit matters (CAMs) identified during audits. CAMs are defined as those matters "*arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee that: (1) relates to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective or complex auditor judgement.*"

If a report highlights that there were no CAMs, the auditor will be required to affirmatively state that in the report. Auditors are now required to elaborate on the factors considered while evaluating as to whether a specific matter rises to the level of a CAM. For this purpose, auditors may also consider any of the non-exclusive factors set out in the standard itself.

Audit reports are further expected to provide investors with information about sensitive issues. This should be done by describing how the identified CAMs were addressed by the company. The SEC expects that a description of auditor's insight into the audit report will make the report more useful and relevant for investors and improve their financial understanding of the company.

Among other disclosures, the report should also contain reasonable assurances made by the auditor that the financial statement does not include any misstatement. To ensure that there is transparency and independence, the auditor is also required to state, in the audit report, that they are an independent auditor in accordance with the federal securities laws. The standard also requires adding titles to each section of the report to improve its readability. These requirements, including disclosure of CAMs, are expected to change the timeline for companies' auditing processes.

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The standard, excluding the CAM disclosure requirements, is applicable to audit reports prepared for the fiscal year ending on or after December 15, 2017. CAM requirements will be effective for large publicly traded companies from the fiscal year ending on or after June 30, 2019. For smaller companies, the CAMs requirements will be applicable in 2020 to allow sufficient time for evaluating the effects of the standard, especially on smaller companies. Companies have an option to voluntarily comply with the standard before the effective date. CAM requirements have been exempted for emerging growth companies, investment companies other than business development companies, and specific broker and dealers.

The introduction of AS 3101 has been seen by commenters as an attempt to meet the level of the international auditing approach, which has moved beyond the traditional "pass/fail" auditing model. The standard aims at educating investors about a company's financial statement in an improved way and paves the way for a better communication between auditors and investors. After a review of the standard's implementation, PCAOB is expected to propose expansion of the standard's scope of applicability.

If you have any questions about this Legal Briefing, please contact any attorney of our Firm at 585-730-4773.

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