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New "Critical Audit Matter" Reporting Requirement Presents Challenges for Independent Auditors and Public Company Audit Committees


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On Oct. 23, 2017, the U.S. Securities and Exchange Commission approved changes to the auditor's standard report proposed by the Public Company Accounting Oversight Board (PCAOB) in amended Auditing Standard 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which generally applies to audits of public companies' financial statements. The comment and approval process took more than six years, and adoption of the amended standard marks the most significant change to the form of the auditor's report since the 1940s. While the standard retains the "pass/fail" format used in current audit opinions, it now requires auditors, among other things, to report on "critical audit matters" arising from the audit or state there were no such matters.

In this Insight, we address:

- What constitutes a critical audit matter ("CAM");
- When the CAM requirement will go into effect; and
- How CAMs may present new challenges for both independent auditors and audit committees.

What Is A Critical Audit Matter?

A CAM is defined 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: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment." Amended AS 3101.11, attached as App. 1 to PCAOB Release No. 2017-001. The guidance provides factors the auditor should consider, including the risk posed of material misstatement, the degree of auditor judgment related to areas involving significant judgment or estimation required by management, the nature and timing of significant unusual transactions and the amount of judgment the auditor must apply to understand those transactions, the degree of subjectivity involved in performing and evaluating audit procedures to address the matter, the amount of effort and specialized skill needed to address the matter, and more. These factors are to be considered "alone or in combination," along with "other factors specific to the audit."

If the auditor determines there are no CAMs, the report must say so, but a note to Amended AS 3101.12(f) states it is "expected" that most audits will address at least one accounting issue involving especially challenging, subjective, or complex auditor judgment. When a CAM is identified, the auditor's report must:

- identify the critical audit matter;

- describe the principal considerations that led the auditor to determine the matter is a critical audit matter;

- describe how it was addressed in the audit; and

- identify the relevant financial statement accounts and disclosures.

When Does the CAM Requirement Go Into Effect?

The provisions related to critical audit matters will take effect for audits for fiscal years ending on or after June 30, 2019, for large accelerated filers, and for audits for fiscal years ending on or after Dec. 15, 2020, for all other companies to which the standard applies. All other paragraphs of the rule and related amendments will be effective for audits of fiscal years ending on or after Dec. 15, 2017. CAMs will not be required in audit reports on the financial statements of emerging growth companies, broker-dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5, and certain other entities.

What Concerns Are Raised by the CAM Requirement?

The CAM reporting requirement presents several potential challenges that auditors and audit committees, as well as their counsel, should be aware of. These include the possible disclosure of original company information by the auditor, resulting confusion over the auditor's role, and increased exposure to litigation.

Materiality

Under the current reporting model, the auditor opines that it obtained reasonable assurance that the company's financial statements, taken as a whole, are free from material misstatement. CAMs, however, relate to particular accounts or disclosures—and not to the financial statements taken as a whole. While the PCAOB ultimately included a materiality component in the amended AS 3101, it applies to the account or disclosure itself. The PCAOB determined that "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," reasoning that "[i]f 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…." PCAOB Release No. 2017-001, at 20. This raises the question of whether more disclosures are always better for investors. One can imagine the CAM portion of an audit report eventually resembling the fine print on a prescription drug label, cluttered with disclosures that are difficult for investors to wade through in the search for material information. This is nonetheless the approach that has been adopted, subject to any future evaluation as to the cost and effectiveness of this formulation.

Confusion Over the Auditor's Role

The disclosure of critical audit matters could lead to confusion regarding the role of company management and the audit committee on one hand, and the independent auditor on the other. Auditors will be required to make their own judgments about whether certain issues that arise in the course of the audit should be disclosed in the audit report, and some commentators have suggested that auditors may be incentivized to include more, rather than fewer, CAMs. This raises the possibility that auditors will end up reporting original information that the company was not required to disclose under SEC rules and regulations, particularly in the portion of the report detailing why the issue was considered a CAM and how it was addressed during the audit. This in turn may cause the company's management to make new disclosures driven by the draft audit report, in effect expanding the company's disclosure obligations beyond what is required by the securities laws. Such disclosure of original information represents a significant departure from the auditor's traditional attestation role and has the potential to chill communications between auditors and their clients.

Additional Litigation Risk

Much of the case law that has developed around auditor liability is premised on the auditor's well-defined role and the limited statements attributable to the auditor. The CAM requirement will increase the number of statements auditors make in their reports to include substantive discussions as to why a particular issue was considered a CAM and how it was addressed during the audit. Plaintiffs might argue that prior precedent should be reevaluated in light of these changes, while auditors will have strong counterarguments available. Although it remains to be seen whether this will cause any disruption to well-settled auditor liability principles, one area that could potentially be impacted involves claims brought under Section 11 of the Securities Act. In *Omnicare, Inc., v. Laborers Dist. Council Constr. Ind. Pension Fund*, the United States Supreme Court held that statements of opinion are only actionable under Section 11 if: (1) the defendant did not honestly hold the opinion issued, or (2) material facts are omitted about the basis of the opinion making the opinion statement at issue "misleading to a reasonable person reading the statement fairly and in context." *Omnicare, Inc., v. Laborers Dist. Council Constr. Ind. Pension Fund*, 135 S. Ct. 1318, 1332 (2015). The Second Circuit, applying *Omnicare*, has held that audit reports are statements of opinion and subject to the *Omnicare* standard. *Querub v. Moore Stephens Hong Kong*, 649 Fed. App'x 55, 58 (2d Cir. 2016). Plaintiffs might assert that CAMs are not purely statements of opinion, but instead include embedded statements of fact.

CAMs may also feature in attempts to plead Section 10(b) claims. In the Second Circuit, plaintiffs can only satisfy their *scienter* burden by alleging particularized facts showing that the auditor had both motive and opportunity to commit fraud, or engaged in conduct constituting strong circumstantial evidence of conscious misbehavior or recklessness. *See*
Iowa Pub. Employee's Ret. Sys. v. Deloitte & Touche LLP, 919 F. Supp. 2d 321, 331 (S.D.N.Y. 2013). The inference of *scienter* must be at least as compelling as any opposing inference of non-fraudulent intent. *Id.* at 331. Courts have held that *scienter* is properly pleaded against an auditor only where the audit amounted to "no audit at all" or there is an alleged "egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *In re Marsh & Mclennan Cos. Sec. Litig*., 501 F. Supp. 2d 452, 488-89 (S.D.N.Y. 2006) (citations omitted). Plaintiffs might attempt to plead scienter by taking issue with the analysis set forth in the CAM portion of the audit report. Under the current reporting standard, plaintiffs would typically not have access to such information prior to discovery.

Some have called on the SEC to exercise its rulemaking authority to expressly limit liability arising from CAMs under the securities laws to statements or omissions known to be false or misleading at the time they were made. While the SEC has not yet taken such action, it states that it expects the PCAOB "to monitor the Proposed Rules after implementation for any unintended consequences." SEC Release No. 34-81916, File No. PCAOB-2017-01, at 33. Such unintended consequences might also extend beyond the securities law context, to include the impact on professional malpractice and other claims brought against auditors under state law.

Conclusion

Several commentators have called for post-implementation monitoring of the effectiveness of CAM disclosures, the impact on costs associated with the audit process (including both audit fees and internal costs incurred by management), and any increase in litigation exposure experienced by accounting firms. For now, however, auditors and audit committees—as well as their counsel—need to be aware of the risks and challenges that the amended AS 3101 might pose.

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