ACCOUNTING TODAY. Why Auditors' Reports are Likely to Get Longer and More Detailed

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We suggest for companies that do not have an audit committee that consideration be given to forming one. If the ASB adopts the CAM standard then any non-exempted company will need an audit committee; getting its members up-to-speed—taking into account the numerous new audit and accounting standards will take time.

Standard Setters. Auditors of public companies are required to follow standards set by the Public Company Accounting Oversight Board (the “PCAOB”), created in the wake of the Financial Crisis to improve reporting standards for public companies. Auditing standards for private companies, however, are issued by the Auditing Standards Board (the “ASB”), a division of the American Institute of Certified Public Accountants (AICPA). Up to now, PCAOB guidance has been more rigorous than the ASB’s, and reports of Auditors, arguably more intrusive under the PCAOB. Recent guidance issued by the ASB indicates their intention to converge with the PCAOB’s standards to a substantial extent, if not presently, that at some future date.

OK but Not Great. The impact of this coming convergence is the subject of this alert. We begin with Critical Audit Matters (“CAMs”), a major change to an auditor’s unqualified opinion. Up to now, opinions have been either “pass” or “fail;” the PCAOB adds a third category, which we will call “OK but Not Great.”   CAMS are items arising from the audit of financial statements that were communicated or were required to be reported to the reporting company’s audit committee. A CAM either (i) is related to accounts or disclosures that are material to the financial statements or (ii) “involved especially challenging, subjective, or complex auditor judgment.” (PCAOB AS 3101). In its welter of discussions of CAMs, very little concrete guidance is offered and bright-line tests (e.g., is an item representing 0.5% of gross receipts worthy of being CAMIFIED?) Instead, the auditor and the audit committee are required to make many judgment calls and many inquiries and tests of various items, even though no CAM is significant enough to cause the auditor’s report to “pass.” PCAOB guidance issued in 2016, in effect, requires the engagement team working on an audit to consider whether to bring in specialists to consult on potential CAMs. Bringing in specialists, whether from the auditors’ firm or third-party experts, will necessarily raise the cost of any audit and delay issuance of the auditor’s report.

The OK but Not Great standard for CAMs is that they must be included in auditors’ reports for fiscal years ending after June 30, 2019, for large filers and for fiscal years ending after December 15, 2020 for all other filers not subject to an exception. CAM disclosure is not required for audits of emerging growth companies, brokers and dealers, investment companies other than business development companies, and employee stock purchase, savings and similar plans. Of critical importance to our readers, there is no de minimus standard for when CAM analysis and disclosure is required. It Is obvious that CAM implementation will be costly, likely to delay the issuance of auditors’ reports, particularly in the early years of CAM disclosures, and confusing to audit committee members.

Because of the imprecise definition of CAMs and the consequences to an auditor of not disclosing them, we believe that the standard will be “when in doubt disclose (CAMs).” We think it likely that audit committees will be under considerable pressure to resolve potential issues so that they do not turn into a CAM that will have to be included in the auditor’s report. Although the ASB has not yet gone as far as the PCAOB in requiring an auditor to disclose reporting company problem audit areas, the ASB’s Chair recently stated that the Board is deliberating on what standard for disclosures of problem areas to adopt, the hardline PCAOB standards or the more lenient international standards. We urge the ASB if they are going to implement the CAM regime, that consideration be given to exempting small, private companies with [the reader should fill in the criteria—under $50 million of gross recdeipts? $25 million of gross receipts? -- first three years of operation? . . . .]

The Lowdown on the Auditors. A second with detailed guidance is the requirement that the auditor disclose its tenure as the auditor of the reporting company and improving communication between the audit committee and the auditors. The PCAOB is concerned with the identity of the accounting firm conducting the audit, the engagement partner (for now this is optional), other accounting firms assisting in the audit, and other auditor-specific information. For example, the audit firm must state the period for which it has been the reporting company’s auditor, including predecessors of the audit firm and the company being audited. There is a special rule for auditor’s of a family of investment companies; the auditor’s tenure dates back to its first audit of a member of the investment company group.

There is for now an optional rule regarding other accounting firms that participated in the audit. The auditor must disclose in its report that the auditor is responsible for the audits or audit procedures performed by other public accounting firms and supervised or performed procedures to assume responsibility for their work in accordance with PCAOB standards. Moreover, if one or more other accounting firms performed at least 5% of the total hours, that firm’s name, address and total hours, or a range of hours, must be provided.

The Trend Is Not Your Friend. The trend is that private companies’ audit procedures and auditor’s reports will come to resemble even more closely those mandated by the PCAOB. We suggest for companies that do not have an audit committee that consideration be given to forming one. If the ASB adopts the CAM standard then any non-exempted company will need an audit committee; getting its members up-to-speed—taking into account the numerous new audit and accounting standards will take time.

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