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*In this edition of our thought leadership publication, we have captured the changes in the auditor's report for public companies in the US.*

### Revolutionary change in the content of auditor's report for public companies in the United States of America

The Public Company Accounting Oversight Board ('PCAOB' or 'the Board') made a revolutionary change in the content of the audit report to enhance transparency to the work performed by auditors. The PCAOB after almost six years of constant comments from public and members of the Board's Standing Advisory Group and Investor Advisory Group brought changes to action.

The Board is adopting a new reporting standard *AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and related amendments to its auditing standards.*

The final standard will 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.

#### Following are the significant changes to the existing auditor's report content:

- **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;

Critical audit matters will be 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.

- **Disclosure of auditor tenure** — the year in which the auditor began serving consecutively as the company's auditor; &
- **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:
  - **Independence:** Auditor's report will now include a statement mentioning the auditor's independence;
  - **Enhancements to basic elements:** Standardized language in the auditor's report has been changed, including adding the phrase "whether due to error or fraud";
  - **Standardized form of the auditor's report:** The opinion will appear in the first section of the auditor's report. Section titles have been added to guide the reader; &
  - **Addressee:** The auditor's report will be addressed to the company's shareholders and board of directors or equivalents (*additional addressees are also permitted*).

*The Securities Exchange Commission on October 23, 2017 unanimously approved the PCAOB's new auditor's reporting standard supporting the communication of "critical audit matters" as a way for auditors to provide more information to investors and the public.*

## The need for the expanded auditor's report was based on various grounds:

- Increasing complexity of global business operations;
- Eliminating the information asymmetry between the auditor and the investor and providing more mix of information to the users of financial statement for making informed investment decisions;
- Incorporating relevancy in the auditors' reporting by including more relevant discussions;
- Dissatisfaction amongst investors relating to the existing content of the auditor's report; &
- Some investors also felt expanded auditor's report would have been helpful before and during the 2008 financial crisis.

## The expected benefits to the financial fraternity:

- More information for valuation analysts to price risk in capital valuation and allocation;
- More focus on key information and highlighting of key areas; &
- Enhances clarity of auditors' roles and responsibilities related to the audit of financial statements, thus making the auditor's report easier to read.

### **Excerpt by PCAOB board member Steven Harris**

*"Today's action is a direct response to calls from investors for the Board to expand the auditor's report to include information about the difficult parts of the audit, and information that the auditor gained from the audit that he or she would like to know as an investor – basically what "kept the auditor awake at night."*

### **Excerpt by SEC Chairman Jay Clayton**

*SEC Chairman Jay Clayton said in a statement that he supports the standard, but he cautioned that some commenters were concerned that divulging critical audit matters would result in an increase in litigation that does not benefit investors, or in boilerplate disclosures. He said he will be disappointed if the new standard results in frivolous litigation costs or defensive, lawyer-driven auditor communications. Because of this, Chairman Clayton said he is pleased that the PCAOB intends to monitor the results of implementation of the standard through its post-implementation review ('PIR') process.*

## Countries like United Kingdom have already adopted expanded auditor's reporting:

United Kingdom has already adopted the expanded auditor's reporting in effect from audit reports of 2013 financial statements of UK listed companies. A good example of an entire audit report of a major UK company under the Financial Reporting Council ('FRC') is the Independent Auditor's Report of KPMG dated February 12, 2014 on its audit of financial statements of Rolls-Royce Holdings, for the year ended December 31, 2013 (*Pages 130-135 of Rolls-Royce Holdings 2013 – Annual Report*).

### *Excerpt of one of the para of expanded auditors report of 2013 Rolls Royce Holdings Annual Report*

*"We found the resulting estimate was acceptable but **mildly optimistic** resulting in a somewhat lower liability being recorded than might have otherwise been the case".*

<https://www.rolls-royce.com/~media/Files/R/Rolls-Royce/documents/investors/annual-reports/rr-full%20annual%20report--tcm92-55530.pdf>

Another example of expanded financial reporting of one of the biggest clothing retail outlets in UK is Marks and Spencer.

<http://corporate.marksandspencer.com/investors/153855a7b7b24038920758283d6986fa>

## Timelines for implementation of the new standard:

A phased implementation will be in place for allowing accounting firms, companies and audit committees more time to prepare for the implementation of the critical audit matters requirements. The final standard and amendment will take effect as follows:

- 1) All provisions other than those related to critical audit matters will take effect for audits for fiscal years ending on or after December 15, 2017.
- 2) Provisions related to critical audit matters will take effect of audits for fiscal years ending on or after June 30, 2019 for large accelerator filers (*includes companies with a public float of US\$ 700 million or more*), 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, as SEC approval of the final standard is now received.

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