The CAM – A New Challenge

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I. Introduction

On October 23, 2017 the Securities and Exchange Commission (the "SEC") issued its Release No. 34-81916; File No. PCAOB-2017-01 in which the SEC approved, without change, the new auditing standard adopted by the Public Company Accounting Oversight Board (the "PCAOB") on June 1, 2017 in its Release No. 2017-01 (the "PCAOB Release"). The new auditing standard, which is entitled "*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*" (the "New Standard"), will be designated AS 3101 and will replace certain parts of existing AS 3101. The remaining parts will be redesignated as AS 3105, "*Departures from Unqualified Opinions and Other Reporting Circumstances*". The New Standard was first proposed by the PCAOB in 2013 (after the issuance in 2011 of a concept release on audit reports) and, following extensive commentary, reproposed in 2016 (the PCAOB proposal and reproposal, together, being referred to herein as the "Proposal"). The New Standard would require, among other things, the inclusion in the audit report of an identification and discussion of each "critical audit matter" ("CAM") that was addressed in the audit.

II. The New Standard

(A) The Audit Report – Basic Requirements

The New Standard retains the current requirement of existing AS 3101 that the audit report contain:

- either an expression of opinion on the financial statements, taken as a whole, or an assertion that an opinion cannot be expressed; and
- if one can be expressed, an unqualified opinion that the financial statements, taken as a whole, present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework (subject to modification, as appropriate, to reflect on the type of company and financial statements being audited).

Thus, the current "pass/fail" scheme is not altered – the audit report contains either an unqualified opinion that the financial statements "fairly present…" or, if an unqualified opinion cannot be given, a qualified opinion, adverse opinion or disclaimer of opinion, as contemplated in AS 3105, or, if such is the case, an assertion that an opinion cannot be expressed. The discussion of a CAM in an audit report that contains an unqualified opinion is not intended to change the unqualified nature of such opinion.

(B) CAM Defined

The New Standard, among other things, introduces the concept of a CAM, which, as defined, is any matter that:

- is communicated to the audit committee (whether or not required to be so communicated) or required to be communicated to the audit committee (whether or not actually so communicated);
- relates to accounts or disclosures that are material to the financial statements (whether or not the matter is material in and of itself); and
- involved especially challenging, subjective or complex judgment on the part of the auditor.

(C) Factors to be Considered

The New Standard sets forth factors to be considered by the independent auditor in determining whether or not a matter is a CAM, including without limitation:

- the auditor's assessment of the risks of material misstatement;
- the degree of auditor judgment related to areas in the financial statements that required significant judgment or estimation by management;
- the nature and timing of significant unusual transactions and the extent of audit effort and judgment with respect to such transactions;
- the degree of auditor subjectivity in applying audit procedures to address the matter or in the evaluation of the results of such procedures;
- the 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 regarding the matter); and
- the nature of audit evidence obtained regarding the matter.

(D) Discussion of CAMs in Audit Report

If a matter is determined by the independent auditor to be a CAM, the New Standard requires that the auditor, in the audit report:

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

(E) Original Information

The PCAOB Release states the PCAOB's expectation that the discussion of a CAM will not include previously undisclosed information, unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter was a CAM or how the matter was addressed in the audit.

III. Communications between Auditors and Audit Committee

The obligations on the part of the independent auditor to bring certain matters to the attention of the audit committee are substantially coextensive with the obligations on the part of the audit committee to review certain matters with the independent auditors.

(A) Obligations of Independent Auditor

By definition, a CAM is a matter that is communicated or required to be communicated to the audit committee. Requirements on the part of the independent auditor to communicate with the audit committee are contained in Section 10A(k) of the Securities Exchange Act of 1934 (the "1934 Act") and Rule 2-07 of Regulation S-X thereunder, as well as AS 1301 "Communications with Audit Committees", including Appendix B thereto. Matters required to be communicated to the audit committee include, without limitation:

- all critical accounting policies and practices;
- alternative treatments of financial information under GAAP that have been discussed with management;
- other material written communications between the auditor and management;
- significant risks identified by the auditor;
- significant unusual transactions; and
- other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

(B) Obligations of Audit Committee

(1) NYSE Rules

The New York Stock Exchange imposes on listed companies several conditions regarding audit committees, including:

- a listed company must have an audit committee meeting the requirements of Rule 10A-3 under the 1934 Act (Rule 303A.06);
- the audit committee must have at least three members, each of whom must be "financially literate" (Rule 303A.07(a));
- the audit committee must meet to review and discuss annual audited and quarterly financial statements with management and the independent auditor (Rule 303A.07(b)(iii)(B)); and
- the audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work. Matters could include "any accounting adjustments that were noted or proposed by the auditor but were 'passed' (as immaterial or otherwise)" (Rule 303A.07(b)(iii)(F)).

Other "national securities exchanges" and "national securities associations" (within the meaning of Sections 6 and 15A, respectively, of the 1934 Act and the regulations thereunder) have similar requirements.

(2) Federal Securities Laws

Item 407(d) of Regulation S-K under the Securities Act of 1933 (the "1933 Act") and the 1934 Act requires that the audit committee include a statement in a proxy statement for an annual meeting of security

holders at which directors are to be elected. The audit committee must state, among other things, whether:

- at least one of its members is a "financial expert" (as defined) and, if not, why not;
- it has reviewed and discussed the financial statements with management; and
- it has discussed with the independent auditors the matters required to be discussed by AS 1301 (noted in subsection (A) above).

It should not surprise if the audit committee were to include, in its report contained in the proxy statement, reference to the CAMs (or the subject matter thereof) discussed in the independent auditor's report.

(C) Discussions of CAMs

Looking at both sides of the coin, it would appear that, during the discussions required of the independent auditors and those required of the audit committee, the subject matter of CAMs will surely take center stage. It would seem prudent for management and members of the audit committee (and perhaps other directors) to make continuing inquiry as to matters that the independent auditor may determine to be CAMs. If issues could be addressed and resolved in advance, perhaps a matter otherwise of concern would no longer be a CAM. If a matter will remain a CAM, the auditor's discussion of the CAM and the company's disclosure of the matter could be synchronized. Finally, to the extent that the auditor's discussion of the CAM is expected to include previously undisclosed information, perhaps the company could determine to disclose such information.

There is considerable overlap between the obligation of the independent auditor to discuss CAMs in the audit report and the obligation of issuers to discuss critical accounting policies, procedures and estimates. SEC Release 33-8040, 34-45149 (Dec. 2001) encourages issuers to include in "MD&A explanations, in plain English, of their 'critical accounting policies', the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions." This overlap invites coordination of the two disclosures by the auditor and the issuer.

IV. Liability Considerations

All parties involved in the preparation, auditing, approval and publishing of financial statements can have liability thereon including liability under the federal securities laws, particularly, but without limitation, Section 11(a) of the 1933 Act and Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

(A) Liability of Auditor

The New Standard will not affect either the duty of the auditor to perform a proper audit in accordance with general auditing standards or the liability of the auditor if it does not, including liability as an expert under Section 11(a) of the 1933 Act. However, as discussed by commenters on the Proposal and noted in the PCAOB Release, the addition of a CAM to the audit report could result in additional theories of liability of the auditor, which could include, without limitation:

- claims based in alleged misstatements or omissions in the statements that identify and describe the CAM;

- claims based on inappropriate accounting for the subject matter of the CAM or otherwise based on the subject matter of the CAM, perhaps arguing, among other things, that the discussion of the CAM implied increased examination or investigation by the auditor and that this justified increased reliance by investors on the audit report (possibly compromising the auditor's ability to argue that the discussion of the CAM, being part of the audit report, is just an opinion);

- claims challenging the procedures followed or the adequacy of the audit evidence obtained;

- claims arising out of examination of the auditor's work papers on the subject matter of the CAM, which would be subject to discovery; and

- claims based on the omission of a CAM from the audit report.

The PCAOB Release also notes that commenters on the Proposal raised concerns that the auditor, in an effort to reduce potential liability, could be induced to include matters that might not fully meet the requirements for communication to the audit committee and discussed as CAMs in the audit report. If it were ultimately determined that there was a problem in the subject matter of a CAM, it is not clear whether the identification and discussion of that subject matter as a CAM would shield the auditor from liability or, on the contrary, increase the auditor's liability as suggested above. In any case, independent auditors may tend to err on the side of caution and over-disclosure.

(B) Liability of the Company

The New Standard will not change the general obligations and liabilities of the company under the federal securities laws, including without limitation Section 11(a) of the 1933 Act. However, as noted in the PCAOB Release, commenters on the Proposal suggested that the discussion of CAMs in the audit report could increase the company's litigation risks:

- for all the possible reasons outlined above with respect to possible increases in the liability of the auditor;

- because the company did not sufficiently address the subject matter of the CAM;

- because the discussion of CAMs in the audit report could be a "road map" for potential plaintiffs; and/or

- if the discussion of the CAM included "original information" not otherwise disclosed by the Company.

(C) Liability of Officers, Directors and Underwriters

Under Section 11(a) of the 1933 Act, in addition to the issuer and its accountants and the other experts, every person who signs a registration statement, every director of the issuer and every underwriter with respect to a security have liability for misstatements and omissions of material facts. However, under Section 11(b), no such person (other than the issuer) has such liability under Section 11(a) if such person can sustain the burden of proof that:

- as to information in the registration statement that is not included on the authority of an expert, such person had, after reasonable investigation, reasonable ground to believe, and did believe, that such information was true and that there was no omission to state a

material fact required to be stated therein or necessary to make the statements therein not misleading; or

- as to the information in the registration statement that is included on the authority of an expert (such as an accountant), such person had no reasonable ground to believe, and did not believe, that such information was untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

Section 11(c) of the 1933 Act provides that, in determining what constitutes "reasonable investigation" and "reasonable ground for belief", "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

Since the identification and discussion by the auditor of a CAM will appear in the audit report, it would seem clear that it is included on the authority of an expert – indeed, it will be a statement made by the expert. This should entitle persons otherwise liable to sustain only the lower burden of proof with respect to the discussion in the audit report itself. However, it remains to be seen whether such person's burden of proof that he or she had no reasonable ground to believe that there was a misstatement or omission in the subject matter of the CAM or in the discussion thereof would, on the contrary, be increased by reason of such person's undeniable awareness of the subject matter of the CAM.

Officers, directors and underwriters, as well as issuers, have liability for misstatements and omissions under many other provisions of the federal securities laws, although §11(a) of the 1933 Act is the most severe. Of particular note is Section 10(b) of the 1934 Act and Rule 10b-5 thereunder. Rule 10b-5, however, requires, among other things, a showing of "scienter" on the part of the defendant. Query whether discussions of the subject matter of a CAM by members of the audit committee and perhaps others with the auditor (presumably well in advance of the completion of the financial statements and the delivery of the audit report) could, depending on the circumstances, be sufficient to establish "scienter" with respect to the subject matter of CAM.

As a result of these uncertainties, it would seem prudent for all persons who would have liability under Section 11(a) of the 1933 Act, and perhaps others, to perform enhanced due diligence with respect to the subject matter of a CAM and the auditor's identification and discussion thereof, notwithstanding that such identification and discussion, and the accounting related thereto, are "expertized" information and notwithstanding, further, that, despite the discussion of the CAM, the auditor still gives the unqualified opinion that the financial statements "fairly present ..."

(D) Differential Liability

The concept of differential liability among directors and officers, under both state law and federal securities law, should be noted briefly. Section 8.30 of the Model Business Corporation Act provides that directors who do not serve on a committee of the board may rely on information prepared or presented by a committee to the extent that such information is within the committee's delegated authority, the director believes the committee merits confidence and the director has no knowledge that would cause such reliance to be unwarranted. Many states, including Delaware and New York, have similar statutes. While non-members of the audit committee thus have some measure of protection from liability, the converse is also true – that members of the committee, who presumably have special expertise or knowledge, have increased responsibility and liability. The concept of differential liability applies equally under the federal securities laws. See, for example, *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) and *Feit* v. *Leasco Data Processing Equipment Corporation, et al.*, 332 F. Supp 544 (E.D.N.Y 1971).

It would appear that the identification and discussion of a CAM in the audit report, following discussions thereof with the audit committee as required, could increase the responsibility and liability of directors and officers generally with respect to the subject matter of the CAM, but especially those with special expertise and responsibility such as the members of the audit committee and the chief executive officer, the chief financial officer and the chief accounting officer.

V. Applicability and Effective Dates

The requirements of the New Standard with respect to CAMs do not apply to the audits of emerging growth companies, certain brokers and dealers, investment companies (other than business development companies) or employee stock purchase, savings or similar plans. Such requirements will become effective

- with respect to audits of large accelerated filers (as defined in Rule 12b-2 under the 1934 Act), for fiscal years ending on or after June 30, 2019; and

- with respect to audits of all other companies to which the requirements apply, for fiscal years ending on or after December 15, 2020.

This note was prepared by J. Anthony Terrell as of October 25, 2017. At the time, Mr. Terrell was a partner in the New York office of an international law firm. He is now of counsel at Bracewell LLP, resident in the New York office. The views expressed here are those of Mr. Terrell and do not necessarily reflect the views of those firms.