

## **CRITICAL AUDIT MATTERS: IMPROVING DISCLOSURE THROUGH AUDITOR INSIGHT**

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### ABSTRACT

*Despite being relatively unchanged for nearly 80 years, starting in 2019 the Independent Auditor's Report will undergo a major update with the addition of critical audit matters. This update improves disclosure, while providing something new to investors — auditor insight and knowledge that was always saved for the Company and the Audit Committee. This new disclosure will help individual investors navigate the data minefield of Form 10-K.*

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## INTRODUCTION

Audit opinions provide assurance<sup>1</sup> to the investing public<sup>2</sup> and creditors who rely on a public company's financial statements.<sup>3</sup> The independent auditor's report, financial statements, and Management's Discussion and Analysis ("MD&A") are all included in Form 10-K,<sup>4</sup> which is filed with the Securities and Exchange Commission ("SEC") and accessible by the public. The independent auditor's report is the sole line of communication between the auditor and the users of the financial statements<sup>5</sup> as the remainder of Form 10-K is written from the company's perspective.<sup>6</sup> Despite the adoption of the MD&A requirement in 1980,<sup>7</sup> technological changes in financial reporting,<sup>8</sup> and the release of new accounting standards,<sup>9</sup> prior to this change, the independent auditor's report has

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<sup>1</sup> SEC. & EXCH. COMM'N, ALL ABOUT AUDITORS: WHAT INVESTORS NEED TO KNOW, (June 24, 2002), <https://www.sec.gov/reportspubs/investor-publications/investorpubsaboutauditorshtm.html>.

<sup>2</sup> See Ken Tysiac, *What Investors Want to See*, J. ACCT., (Oct. 25, 2017), <https://www.journalofaccountancy.com/news/2017/oct/what-investors-are-looking-for-201717738.html> (noting that in a survey by the Center of Audit Quality, 84% of investors expressed confidence in external auditors).

<sup>3</sup> A company's financial statements include: (1) Balance Sheet: "[A] snapshot of the company's assets (such as cash and inventory) and its liabilities (such as outstanding debt)" and (2) Income Statement: the report of the revenue earned and the expenses incurred to earn that revenue. See Nellie S. Huang, *Make the Most of an Annual Report*, KIPLINGER'S PERSONAL FINANCE, Mar. 2014, at 41.

<sup>4</sup> U.S. Sec. & Exch. Comm'n, FAST ANSWERS: FORM 10-K, (June 26, 2009), <https://www.sec.gov/fast-answers/answers-form10khtm.html> ("The annual report on Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements.").

<sup>5</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS AND RELATED AMENDMENTS TO PCAOB STANDARDS 2 (2011).

<sup>6</sup> The majority of 10-Ks today is Management's Discussion & Analysis ("MD&A"), which is written from the perspective of the filer. See 17 C.F.R. § 229.303(a) (2017) (providing that MD&A must include "other information that *the registrant* believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.") (emphasis added).

<sup>7</sup> Troy Paredes, *After the Sarbanes-Oxley Act: The Future Disclosure System: Blinded By the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U.L.Q. 417, 425 n.27 (2003).

<sup>8</sup> The SEC now requires that all documents are filed electronically and that they include data tags to "identify key items in financial statements using a standardized taxonomy." This is known as XBRL. Erik F. Gerding, *Disclosure 2.0: Can Technology Solve Overload, Complexity, and Other Information Failures?*, 90 TUL. L. REV. 1143, 1169 (2016).

<sup>9</sup> See generally REVENUE FROM CONTRACTS WITH CUSTOMERS, Statement of Fin. Accounting Standards No. 606 (Fin. Accounting Standards Bd. 2014). Changes in accounting standards affect comparability between periods covered by financial reports). See generally Denise Dickins et al., *Not All PCAOB Inspections Are Created Equal*, THE CPA JOURNAL (Aug. 2017), <https://www.cpa-journal.com/2017/08/30/not-pcaob-inspections-created-equal/>.

remained consistent since the 1940s.<sup>10</sup> These opinions are relatively short, at one or two pages in length,<sup>11</sup> considering that many 10-Ks are over 100 pages.<sup>12</sup>

Audit opinions traditionally followed a “pass/fail” model.<sup>13</sup> A passing opinion concluded that the company’s financial statements “present[ed] fairly, in all material respects,”<sup>14</sup> but provided no detail on any areas of the audit that were higher risk, complex, or required additional time. Conversely, when a company failed the audit, the auditors issued either: (1) a “qualified opinion” which concluded that the financial statements presented fairly except for the noted issues,<sup>15</sup> or (2) an “adverse opinion” which concluded that the financial statements did not present fairly<sup>16</sup> that explained why the financial statements were not in conformity with Generally Accepted Accounting Principles (“GAAP”).<sup>17</sup>

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<sup>10</sup> Notice of Filing of Proposed Rules on the Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures From Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards, 82 Fed. Reg. 35395, 35396 (July 28, 2017) [hereinafter Notice of Filing of Proposed Rules]. *But see* Sarbanes Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, § 103(a)(2)(A)(iii) (2002) (requiring the issuance of an internal controls opinion in addition to the traditional auditor’s report).

<sup>11</sup> Despite their relatively short length, audit opinions represent the culmination of a substantial number of hours by audit firms to perform all the procedures necessary to issue these opinions. The average public audit is 22,539 hours. FINANCIAL EXECUTIVES RESEARCH FOUNDATION, 2016 ANNUAL AUDIT FEE SURVEY (2016). Auditor’s time is spent understanding the Company, its internal control environment, and inspecting the Company’s books and records, including testing account balances and assessing the adequacy of disclosures. *See, e.g.*, ALL ABOUT AUDITORS: WHAT INVESTORS NEED TO KNOW, *supra* note 1.

<sup>12</sup> *See generally* Berkshire Hathaway, Annual Report (Form 10-K) (Feb. 27, 2017); Macy’s Inc., Annual Report (Form 10-K) (Mar. 29, 2017); The Goldman Sachs Group, Inc., Annual Report (Form 10-K) (Feb. 27, 2017).

<sup>13</sup> Michael Cohn, *SEC Approves PCAOB Expanded Audit Report Standard*, ACCOUNTING TODAY (Oct. 23, 2017), <https://www.accountingtoday.com/news/sec-approves-pcaob-expanded-auditor-reporting-model-standard>.

<sup>14</sup> A passing opinion is known in the audit industry as an unqualified opinion. *See id.*; *see also* Berkshire Hathaway, Annual Report (Form 10-K) (Feb. 27, 2017).

<sup>15</sup> REPORTS ON AUDITED FINANCIAL STATEMENTS, Statement on Auditing Standards 3101.20 (Pub. Co. Accounting Oversight Bd. 2017).

<sup>16</sup> DEPARTURES FROM UNQUALIFIED OPINIONS & OTHER REPORTING CIRCUMSTANCES, Statement on Auditing Standards 3105 (Pub. Co. Accounting Oversight Bd. 2017).

<sup>17</sup> All financial Statements/Form 10-K filed with the SEC “must be prepared in accordance with (or reconciled to) generally accepted accounting principles . . . [and] shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.” 15 U.S.C. § 78m(i) (2017).

Federal securities laws are designed to protect the “reasonable investor.”<sup>18</sup> However, multiple schools of thought exist as to whether the “reasonable investor” is an institutional investor,<sup>19</sup> an individual investor, or if this term is capable of having a single definition.<sup>20</sup> Individual and institutional investors have different needs and goals, which is why it is important to identify which group of investors the laws are designed to protect. The use of “reasonable investor” in this Note refers to an individual investor, a definition supported by Congress’ intent.<sup>21</sup> As noted by the SEC Investor Advocate, individual investors tend not to participate in the notice and comment process of administrative rulemaking.<sup>22</sup> By using this definition of “reasonable investor,” this Note focuses on this underrepresented but affected group.<sup>23</sup>

Currently in the U.S. financial reporting landscape, there is a broad goal to update existing disclosures. The SEC adopted “a comprehensive ‘Disclosure Effectiveness Initiative’ to review and modernize public company reporting requirements in Regulation S-K and Regulation S-X.”<sup>24</sup> A focus of this initiative is to eliminate provisions that are “duplicative, overlapping, outdated, or unnecessary.”<sup>25</sup> Congress echoed the need to update public company financial disclosures, specifically Regulation S-K, in 2012 in the Jumpstart Our Business Startups (“JOBS”) Act and in 2015 in the Fixing Americas Surface

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<sup>18</sup> TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (acknowledging the “reasonable investor” in that when defining “materiality,” it should be based on whether the reasonable investor would change their vote as a result of the information).

<sup>19</sup> See Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1583 (2017) (noting that “highly sophisticated institutional investors are the appropriate audience for corporate disclosure”).

<sup>20</sup> See generally Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U.L. REV. 461 (2015).

<sup>21</sup> *Id.* at 466 n.24 (citing HR REP NO. 73-1383). See also Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1583 (2017) (stating that Congressional intent was the “average investor” as shown by comments using the terminology “informed lay person” and the plain English disclosure requirements).

<sup>22</sup> Rick A. Fleming, Investor Advocate, U.S. Sec. & Exch. Comm’n, Speech, Moving Forward with the Commission’s Disclosure Effectiveness Initiative (Nov. 19, 2016) (transcript available at [sec.gov](http://sec.gov)).

<sup>23</sup> The claim that individual investors are not participating in the notice and comment process is supported by the majority of submissions in notice and comment process on the final standard from law firms, accounting firms, and individuals who hold financial reporting positions at companies affected by the change in reporting requirements.

<sup>24</sup> Speech by Rick A. Fleming, *supra* note 21. Regulation S-K contains the requirements for disclosure in financial statements by public companies. Regulation S-X contains the rules for the financial statements (Balance Sheet, Income Statement, Statement of Cash Flows, and Statement of Stockholders Equity) which are included in the quarterly and annual public filings. U.S. Sec. & Exch. Comm’n, RULES, REGULATIONS & SCHEDULES, (Oct, 13, 2017), <https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml>.

<sup>25</sup> *Id.*

Transportation (“FAST”) Act.<sup>26</sup> Following the PCAOB, the American Institute of Certified Public Accountants (“AICPA”) Auditing Standards Board, which issues standards that cover audits of non-issuers, proposed changes to their audit opinion standards that would closer align them with the CAM standard.<sup>27</sup> The Auditor’s Report standard (Audit Standard 3101), issued by the PCAOB, is part of the broader initiative to update disclosure.

This Note argues that Audit Standard 3101 should include a presumption that “significant risks” are “Critical Audit Matters” (“CAM”).<sup>28</sup> Although the “CAM” disclosure is usable to individual investors, further updates to existing disclosures must be made to close the gap between institutional and individual investors. Part I discusses Audit Standard 3101 and the legislative history leading to the final standard promulgated by the SEC. Part II describes the U.S. federal securities laws and the issues that the disclosure system attempts to address. Part III argues for a presumption that all significant risks are “Critical Audit Matters.” Finally, Part IV addresses the cost of implementing the standard with the proposed changes.

## I. THE ROAD TO SEC APPROVAL & THE FINAL STANDARD UNDER AS 3101

This section begins with an overview of the “Critical Audit Matters” standard that goes into effect for large accelerated filers, those with public float exceeding \$700 million, in 2019.<sup>29</sup> Afterwards, this section provides an overview

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<sup>26</sup> *Id.* Congress’s intent on this issue is also evidenced by their inclusion of requirements that the SEC study disclosure and its simplification in the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, § 108 (2012) and the Fixing Americas Surface Transportation Act Pub. L. No. 114-94, 129 Stat. 1312, § 72002 (2015).

<sup>27</sup> See Michael Cohn, *AICPA Proposes Changes in Auditor’s Report*, ACCOUNTING TODAY (Nov. 30, 2017), <https://www.accountingtoday.com/news/aicpa-proposes-changes-in-auditors-report> (noting the AICPA’s proposed standard of “Communicating Key Audit Matters in the Independent Auditor’s Report”).

<sup>28</sup> Notice of Filing of Proposed Rules, *supra* note 10, at 35396 (July 28, 2017). Auditors assign risks levels to each area of the audit. “Significant risk” is the highest risk level that can be assigned to an area. As the risk level increases, audit procedures and considerations are made with respect to that area.

<sup>29</sup> Although the “Critical Audit Matters” disclosure will not be included in audit reports until 2019, some practitioners are initiating conversations with their clients about what will likely be “Critical Audit Matters” and what types of information will be disclosed about them. See, e.g., Michael Cohn, *Audit Committees will be Dealing with New Accounting Standards and Tax Reform This Year*, ACCOUNTING TODAY (Jan. 10, 2018), <https://www.accountingtoday.com/news/audit-committees-will-be-dealing-with-new-accounting-standards-and-tax-cuts-this-year>; see also Pub. Co. Accounting Oversight Bd., *Staff Guidance- Changes to the Auditor’s Report Effective for Audits of Fiscal Years Ending on or After December 15, 2017* (Dec. 28, 2017) (noting that companies may disclose CAMs in the audit reports, prior to the requirement for their inclusion in 2019). See generally FAST ANSWERS: FORM 10-K, *supra* note 4.

the legislative history leading up to approval, including some examples of changes effected in response to public comments.

A. *The Final Standard: AS 3101 The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion*

The final standard, AS 3101 *The Auditor's Report on the Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires the following changes to the Independent Auditor's Report: (1) "Communication of Critical Audit Matters;" (2) "Disclosure of Auditor Tenure;" and (3) improvements to "clarify the auditor's role and responsibilities."<sup>30</sup> This Note focuses solely on change (1).<sup>31</sup>

"Critical Audit Matters" are "communicated or required to be communicated to the audit committee" and both "(1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment."<sup>32</sup> The threshold question in this multi-prong analysis is whether the matter was communicated to the audit committee.<sup>33</sup> Currently, auditors are required to communicate with the audit committee the Company's "significant accounting policies and practices," "critical accounting policies and practices," "critical accounting estimates," and

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<sup>30</sup> Notice of Filing of Proposed Rules, *supra* note 10 at 35396.

<sup>31</sup> This note will not discuss the issue of auditor tenure as this information could be obtained by reviewing prior years 10-Ks that are publicly available. Further, audit committees have increasingly been disclosing this information on their own without a requirement. CTR. FOR AUDIT QUALITY, AUDIT COMMITTEE TRANSPARENCY BAROMETER 4 fig. 2 (2017). Additionally, the potential risk that one firm is a company's auditor for a long duration is mitigated by the Audit Partner Rotation Rule that limits an audit partners service with the same public company to 5 years. 15 U.S.C. § 78j-1(j) (2017). This risk is further mitigated in large multinational public companies by regulations in other jurisdictions that require that companies change auditors periodically. However, there is no similar requirement in the U.S., which has resulted in companies keeping the same auditors for long periods of time, in some cases even over 100 years. *See, e.g.,* Michael Rapaport, *At GE, KPMG Keeps its 109-Year Streak Alive*, WALL ST. J. (Mar. 13, 2018), <https://blogs.wsj.com/moneybeat/2018/03/13/at-ge-kpmg-keeps-its-109-year-streak-alive/>.

<sup>32</sup> THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.11 (Pub. Co. Accounting Oversight Bd.).

<sup>33</sup> The audit committee is a sub-committee of the Board of Directors. Under section 301 of the Sarbanes Oxley Act, it is required to be composed of independent board members and a financial expert. Adriaen M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure Under the SEC's New Rules Governing Public Company Audit Committees*, 23 ANN. REV. BANKING & FIN. L. 673, 706 (2004). The Financial Expert is required to understanding GAAP, have experience preparing or auditing financial statements, understand internal control & audit committee functions. *Id.*

“significant unusual transactions.”<sup>34</sup> These communications are supplemented by any other issues or topics that the auditor chooses to discuss.<sup>35</sup>

If all the CAM requirements are met, the auditor’s report must include: a description of the CAM, the reasons why it was determined to be a critical audit matter, how this “matter was addressed during the audit” — which may include a description of the procedures performed and the results of those procedures — and the financial statement accounts and disclosures it affects.<sup>36</sup>

### B. *Legislative History*

In response to the Great Recession of 2008-2009, the PCAOB<sup>37</sup> published a concept release on updating the Independent Auditor’s Report.<sup>38</sup> The proposed updates would “increase [the audit report’s] transparency and relevance to financial statement users”<sup>39</sup> and “enhanc[e] communication to investors.”<sup>40</sup> As part of their outreach, the PCAOB held a series of discussions with financial statement users including institutional investors, investor advocates, money managers, auditors, and members of academia.<sup>41</sup> Investors stated that they valued the audit because of the vast information available to external auditors and insight

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<sup>34</sup> COMMUNICATIONS WITH AUDIT COMMITTEES, Statement on Auditing Standards 1301.12 (Pub. Co. Accounting Oversight Bd.). However, these standards do not clearly define a threshold for what is significant. *See generally id.*

<sup>35</sup> An examples includes feedback on how to improve the audit process. *See* EY Center for Board Matters, *Staying on Course a Guide for Audit Committees*, 1, 21 (2014), [http://www.ey.com/Publication/vwLUAssets/A\\_guide\\_for\\_audit\\_committees/\\$FILE/EY-Staying-on-course-guide-for-audit-committees.pdf](http://www.ey.com/Publication/vwLUAssets/A_guide_for_audit_committees/$FILE/EY-Staying-on-course-guide-for-audit-committees.pdf).

<sup>36</sup> THE AUDITOR’S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.14 (Pub. Co. Accounting Oversight Bd. 2017).

<sup>37</sup> The Public Company Accounting Oversight Board was created by Congress under the passage of the Sarbanes Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, § 101(a) (2002). The purpose of this board was “to oversee the audit of public companies . . . in order to protect the interests of investors and further the public interest in the preparation of information, accurate and independent audit reports . . .” The PCAOB’s responsibilities include “standard-setting, registration and inspection of audit firms, and enforcement authority.” SEC. & EXCH. COMM’N, STATEMENT IN CONNECTION WITH THE 2017 AICPA CONFERENCE ON CURRENT SEC AND PCAOB DEVELOPMENTS (Dec. 4, 2017), <https://www.sec.gov/news/speech/bricker-2017-12-04>. In *Free Enterprise Fund v. Public Company Accounting Oversight Board*, the Supreme Court held the PCAOB constitutional. *See* 561 U.S. 477 (2010) (holding that two-level removal protections from PCAOB was unconstitutional).

<sup>38</sup> *See generally* PUB. CO. ACCOUNTING OVERSIGHT BD., CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS AND RELATED AMENDMENTS TO PCAOB STANDARDS (June 21, 2011), [https://pcaobus.org/Rulemaking/Docket034/Concept\\_Release.pdf](https://pcaobus.org/Rulemaking/Docket034/Concept_Release.pdf) [hereinafter 2011 Concept Release].

<sup>39</sup> *Id.* at 2.

<sup>40</sup> *Id.* at 3.

<sup>41</sup> *Id.* at app. C at C-1.



auditors have as an “independent third party.”<sup>42</sup> Investors noted that auditors had a “better perspective regarding the risks of material misstatement in a Company’s financial statements.”<sup>43</sup> The caveat attached to this praise was that the audit report did not “adequately communicate the results of such an extensive audit process.”<sup>44</sup>

Standards proposed by the PCAOB undergo notice and comment procedures but must ultimately be approved by the SEC to become binding law.<sup>45</sup> After both the initial proposed standard and the re-proposed standard, the PCAOB sought comment from the public, including accounting firms, law firms, and company representatives. Once the final standard was submitted to the SEC in July 2017,<sup>46</sup> and subsequently published in the Federal Register, the SEC had their own notice and comment period prior to approving the current standard on October 23, 2017.<sup>47</sup>

Some commentators expressed concern that the CAM disclosure would include non-public information.<sup>48</sup> This concern was grounded in the belief that “the issuer should be the original source of any disclosure about the issuer or its results of operations or financial position.”<sup>49</sup> The PCAOB failed to address these commentators’ unease in the original drafting in 2013,<sup>50</sup> but subsequently addressed it in 2017 by adding the following language: “[T]he auditor is not expected to provide information about the company that has not been made

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<sup>42</sup> *Id.* at 7.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at C-2. The PCAOB Investor Advisory Group survey found that transparency into the audit process would be beneficial to capital markets by decreasing uncertainty. *Id.*

<sup>45</sup> SEC. & EXCH. COMM’N, ORDER GRANTING APPROVAL OF PROPOSED RULES ON THE AUDITOR’S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, AND DEPARTURES FROM UNQUALIFIED OPINIONS AND OTHER REPORTING CIRCUMSTANCES, AND RELATED AMENDMENTS TO AUDITING STANDARDS RELEASE NO. 34-81916 10 (Oct. 23, 2017), [hereinafter SEC ORDER GRANTING APPROVAL].

<sup>46</sup> SEC. & EXCH. COMM’N, FORM 19B-4 PROPOSED RULES BY PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, FILE NO. PCAOB 2017-01 1 (July 19, 2017).

<sup>47</sup> See generally SEC ORDER GRANTING APPROVAL, *supra* note 45.

<sup>48</sup> See New York City Bar Committee on Financial Reporting, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228394-160810.pdf> (resulting in auditor becoming management); see also Sullivan & Cromwell LLP, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2227828-160777.pdf>.

<sup>49</sup> Sullivan & Cromwell LLP, *supra* note 48 (emphasis added).

<sup>50</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., PROPOSED AUDITING STANDARDS- THE AUDITOR’S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION; THE AUDITOR’S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR’S REPORT; AND RELATED AMENDMENTS TO PCAOB STANDARDS, PCAOB RELEASE NO. 2013-005 app. A at 7-8 (Aug. 13, 2013), [https://pcaobus.org/Rulemaking/Docket034/Release\\_2013-005\\_ARM.pdf](https://pcaobus.org/Rulemaking/Docket034/Release_2013-005_ARM.pdf) [hereinafter 2013 PROPOSED AUDITING STANDARDS].

publicly available by the company,”<sup>51</sup> suggesting that they agreed with the underlying premise of this comment.

The chance of CAM disclosures revealing non-public information about the issuer is small.<sup>52</sup> Other sections of Form 10-K likely contain the information that would appear in the CAM disclosure because materiality<sup>53</sup> is a component of both the broad categories that MD&A covers<sup>54</sup> and the first prong of the “Critical Audit Matters” analysis.<sup>55</sup> Thus, the only new information revealed by CAM disclosures would be the insight unique to the perspective and procedures of the auditor,<sup>56</sup> which is not specific to the issuer or its financial position.

The following example demonstrates where the information about the issuer in a CAM disclosure could be found elsewhere in Form 10-K. The PCAOB utilized “the auditor’s evaluation of the company’s ability to continue as a going concern” — the risk that the company would no longer be able to continue operating for a reasonable time — as an example of a CAM.<sup>57</sup> The facts supporting a determination that the entity is no longer able to continue as a going concern would likely be addressed in the liquidity section of MD&A, as liquidity issues may be strong negative evidence that the Company is unable to continue as a going concern.<sup>58</sup> Therefore, if going concern was a CAM, the new information in the disclosure would only include the audit procedures, such as “[r]eview of compliance with the terms of debt and loan agreement” and “[c]onfirmation with related and third parties of the details of arrangements to provide or maintain

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<sup>51</sup> THE AUDITOR’S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.14 n.2 (Pub. Co. Accounting Oversight Bd. 2017).

<sup>52</sup> See *id.* (focusing primarily on the risk that the auditors would disclose original information regarding control deficiencies).

<sup>53</sup> It is highly likely that these materiality definitions would be given the same meaning to promote consistency within the federal securities laws. See James J. Brudney & Coret Ditslear, *Canons of Construction and the Elusive Quest for Neutral Reasoning*, 58 VAND. L. REV. 1, 13 (2005).

<sup>54</sup> 17 C.F.R. § 229.303(a)(1)-(5) (2017) (including: Liquidity, Capital Resources, Results of Operations, Off Balance Sheet Arrangements and Contractual Obligations).

<sup>55</sup> Notice of Filing of Proposed Rules, *supra* note 10, at 35396 (“Critical Audit Matters” must “[r]elate to accounts or disclosures that are material to the financial statements.”).

<sup>56</sup> *Id.* at 35404.

<sup>57</sup> *Id.* at 35399; see THE GOING CONCERN PRINCIPLE, *Accounting Tools*, (Aug, 23, 2017), <https://www.accountingtools.com/articles/2017/5/14/the-going-concern-principle>.

<sup>58</sup> CONSIDERATION OF AN ENTITY’S ABILITY TO CONTINUE AS A GOING CONCERN, Statement on Auditing Standards 2415 (Pub. Co. Accounting Oversight Bd.) (identifying examples of conditions and events which in the aggregate may indicate the doubt of ability to continue as a going concern which includes “default on loan or similar agreements, . . . restructuring of debt, noncompliance with statutory capital requirements”); see also PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO.3, AUDIT CONSIDERATIONS IN THE CURRENT ECONOMIC ENVIRONMENT 15 (Dec. 5, 2008) (noting the strain on liquidity as a result of changes in the overall economic environment of the Company may affect the Company’s ability to continue as a going concern).

financial support” and insight from the results of those procedures.<sup>59</sup> The use of the materiality threshold in the definition of CAMs and the overlap between the analysis of a CAM and the requirements of MD&A both support the conclusion that disclosure of CAMs will not result in the disclosure of information that was not otherwise publicly available.

In response to comments received during the notice and comment period, the original proposed standard from August 2013 was subsequently revised to clarify and make more specific the CAM factors. The original proposal described CAMs as those involving “difficult, subjective or complex auditor judgment.”<sup>60</sup> The original proposed factors referenced changes in the risk assessment based on the audit evidence obtained, but failed to mention significant risks.<sup>61</sup> In response to commentator suggestions, the CAM factors were updated in 2016<sup>62</sup> to include “[t]he auditor’s assessment of the risks of material misstatement, including significant risks.” Furthermore, the original proposed standard did not include the threshold requirement that the “Critical Audit Matter” be communicated to the audit committee. Instead, the original proposed standard included audit committee communications on a list used to identify as being “of such importance” as to be “Critical Audit Matters.”<sup>63</sup> The audit committee communication threshold requirement was added to the re-proposed standard in 2016 in response to commentator suggestions.<sup>64</sup> The PCAOB noted that this change aligned with the component of the CAM definition “challenging, subjective, or complex auditor judgments.” These type of matters would likely have been communicated to the audit committee anyway, given the committee’s oversight role.<sup>65</sup>

The addition of the audit committee communication threshold requirement raised concern that this standard would chill communications between the Auditor and the Audit Committee<sup>66</sup> and cause auditors to hesitate

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<sup>59</sup> CONSIDERATION OF AN ENTITY’S ABILITY TO CONTINUE AS A GOING CONCERN, *supra* note 58.

<sup>60</sup> 2013 PROPOSED AUDITING STANDARDS, *supra* note 50 at app. 1 at A1-7.

<sup>61</sup> *Id.* app. 1 at A1-7.

<sup>62</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., PROPOSED AUDITING STANDARD- THE AUDITOR’S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS 23 (May 11, 2016) [hereinafter 2016 PROPOSED AUDITING STANDARD].

<sup>63</sup> 2013 PROPOSED AUDITING STANDARDS, *supra* note 50, at app. 1 at A1-6–A1-7.

<sup>64</sup> 2016 PROPOSED AUDITING STANDARDS, *supra* note 62, at 17.

<sup>65</sup> *Id.*

<sup>66</sup> See Cleary Gottlieb Steen & Hamilton LLP, Comment Letter on PCAOB 2017-01 (Aug. 24, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2243327-160867.pdf>; see also Nasdaq, Comment Letter on PCAOB 2017-01 (Aug. 24, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2242843-160854.pdf>; New York City Bar Committee on Financial Reporting, *supra* note 48; Regions Financial Corp., Comment Letter on PCAOB 2017-01 (Aug. 17, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228209-160803.pdf>; Sullivan & Cromwell LLP, *supra* note 48.

“before every communication to consider the potential CAMs implications.”<sup>67</sup> It is well understood that open communication between the auditor and audit committee leads to better financial reporting.<sup>68</sup> When responding to the possible chilling effect, the PCAOB and SEC both stated that communications from auditor to audit committee would not be chilled because the auditing standards require certain communications.<sup>69</sup> If auditors fail to make required communications, they will be checked by PCAOB inspections. Thus, from the PCAOB and SEC perspective, this risk related specifically to discretionary audit committee communications that “fall[] within the scope of a CAM.”<sup>70</sup>

Additionally, the communication from the audit committee to the auditor will also retain the status quo because the audit committee has vast responsibilities and is entirely independent<sup>71</sup> from the organization. Audit committees have the formal responsibilities of appointing and overseeing the auditors.<sup>72</sup> They ensure that the audit firm has the resources and information necessary to issue their report. In recent years, audit committees have increased their involvement by discussing the scope of the audit and whether they feel that any further procedures need to be performed.<sup>73</sup> Furthermore, board members, a subset of which form the audit committee, may be subject to liability for failing to perform their fiduciary duties.<sup>74</sup> In sum, audit committee members have an

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<sup>67</sup> U.S. Chamber of Commerce, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228364-160809.pdf>.

<sup>68</sup> See Cleary Gottlieb Steen & Hamilton LLP, *supra* note 66. This was also acknowledged by Jay Clayton, SEC Chairman, in his public statement on October 23, 2017, but he also stressed the importance of audit committees in producing quality public financial reporting. Jay Clayton, Sec. & Exch. Comm’n, Statement on SEC Approval of the PCAOB’s New Auditor’s Reporting Standard (Oct. 23, 2017) (transcript available at [sec.gov](http://sec.gov)).

<sup>69</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 28.

<sup>70</sup> *Id.*

<sup>71</sup> Independence of all audit committee members is required by the NYSE and Nasdaq listing standards, as well as the SEC Rules. Jody K. Upham, *Audit Committees: The Policemen of Corporate Responsibility*, 39 TEX. J. BUS. L. 537, 546 (2004). The SEC rules provide that an audit committee member is independent if they do not receive any other compensation from the Company except their board and audit committee compensation and that they are not affiliated with the Company or any of its subsidiaries. *Id.* at 547.

<sup>72</sup> H. David Sherman et al., *The Audit Committee’s New Agenda*, HARV. BUS. REV. 92, 92 (June 2009).

<sup>73</sup> EY Center for Board Matters, *supra* note 34, at 21; see also Tatyana Shumsky, *Audit Committees Tell Investors More About Their Work*, WALL ST. J. (Nov. 1, 2017), <https://blogs.wsj.com/cfo/2017/11/01/audit-committees-tell-investors-more-about-their-work/> (recognizing the increase in information provided regarding the Audit Committee process to select the auditor and evaluate their work).

<sup>74</sup> Directors fiduciary duties include both the duty of care and the duty of loyalty. Under Delaware Corporate law, which applies to many public company disputes because a majority of public companies are incorporated in Delaware, Directors cannot be exculpated for breaches of the duty of loyalty which requires that they act in the best interest of the corporation and its shareholders. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2017).

incentive to act in the best interest of shareholders,<sup>75</sup> who are ultimately paying for the audit. The communications between these parties will remain at the existing level, and potentially increase as the audit committee continues to expand its role. Despite the changes made during the notice and comment period, further changes — such as the addition of the significant risk requirement discussed in Part III — can still be made.

## II. THE U.S. FEDERAL SECURITIES LAWS & THE NECESSARY BALANCING ACT OF DISCLOSURE

This section provides a brief overview of the U.S. federal securities landscape and its role in the public securities markets. Part A discusses the role of federal securities laws generally. Parts B and C discuss the issues federal securities laws attempt to resolve, while also acknowledging the potential consequences of overcorrecting these problems. Finally, Part D introduces characteristics of effective disclosure that benefit individual investors in the marketplace.

### A. *The Role of the Federal Securities Laws*

Disclosure is the precursor to “informed judgment.”<sup>76</sup> Without it, investors cannot make decisions, good or bad.<sup>77</sup> Disclosure must be directed at and tailored to the investor to be usable.<sup>78</sup> There is a need for “credible disclosure”<sup>79</sup> and thus, the need for auditors<sup>80</sup> and a regulatory system in this arena.

Securities laws “put investors into a position from which they can help themselves.”<sup>81</sup> The SEC protects investors<sup>82</sup> and maintains “fair and honest markets.”<sup>83</sup> Congress and the SEC protect market participants<sup>84</sup> through securities

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<sup>75</sup> Sherman et al., *supra* note 72 at 98.

<sup>76</sup> Paredes, *supra* note 7, at 422 n.17 (citing SEC Release 33-5223).

<sup>77</sup> *Id.*

<sup>78</sup> Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U.L. REV. 1089, 1091 (2007).

<sup>79</sup> Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 407 (2001).

<sup>80</sup> Wm. Dennis Huber, *The Myth of Protecting the Public Interest: The Case of the Missing Mandate in Federal Securities Law*, 16 J. BUS. & SEC. L. 401, 422 (2016).

<sup>81</sup> *Basic v. Levinson*, 485 U.S. 224, 259 (1988).

<sup>82</sup> Paredes, *supra* note 7, at 422 n.17; *See also* Huber, *supra* note 80, at 402 (noting that the SEC’s mission is “to protect the public interest”).

<sup>83</sup> Huber, *supra* note 80, at 417 (citing 15 U.S.C.S. § 78b).

<sup>84</sup> *Id.* at 418.

regulation by allowing for “efficient and competitive capital formation,”<sup>85</sup> which is possible through accurate pricing of securities.<sup>86</sup> Without mandatory disclosure under the federal securities laws, the information voluntarily disclosed would be insufficient to inform investors in their decision making.<sup>87</sup>

Under the Securities & Exchange Act of 1934 (“1934 Act”), certain “issuers” are required to file reports with the SEC to keep the information in their registration statements current.<sup>88</sup> Although the 1934 Act lists what information companies must disclose, it fails to define the term “disclosure.”<sup>89</sup> Based on these regulations and their guidance, it seems clear that the intent of disclosure was, as noted above, to protect investors and allow for fair dealings in securities. The SEC provided that “[a] disclosure law would provide the best protection for investors. In other words, if the investor had available to him all the material facts concerning a security, he would then be in a position to make an informed judgment whether or not to buy.”<sup>90</sup> This sentiment is echoed by the idea that disclosure of information leads to accurate pricing of securities,<sup>91</sup> which the efficient capital market hypothesis incorporates.

There are different forms of the efficient capital market hypothesis based on the information available in the market. Under the “strongest form,” all existing, available public and private information is reflected in securities prices.<sup>92</sup> In the “semi-strong form,” securities prices reflect only past prices and currently available public information.<sup>93</sup> The U.S. securities market operates in the “semi-strong form”<sup>94</sup> because companies maintain information privately<sup>95</sup> with only certain information made public due to government intervention through required disclosure. In any form of the efficient capital markets hypothesis less than the “strong form,” disclosure improves market efficiency as

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<sup>85</sup> *Id.* at 419.

<sup>86</sup> Dalley, *supra* note 78, at 1094.

<sup>87</sup> Paredes, *supra* note 7, at 421.

<sup>88</sup> 15 U.S.C. § 78m (2017).

<sup>89</sup> 15 U.S.C. § 78c (2017).

<sup>90</sup> Paredes, *supra* note 7, at 423 n.17 (citing SEC Release 33-5223); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining “material” as information that would cause investors to reconsider their vote).

<sup>91</sup> Edmund Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 764 (1995).

<sup>92</sup> Paul Ferrillo et al., *The “Less Than” Efficient Capital Markets Hypothesis: Requiring More Proof From Plaintiffs in Fraud-On-The-Market Cases*, 78 ST. JOHN’S L. REV. 81, 103 (2004); *see also* Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 250 (2002).

<sup>93</sup> Ferrillo et al., *supra* note 92, at 84.

<sup>94</sup> Ferrillo et al., *supra* note 92, at 103 (“All public information is incorporated into stock price s.”).

<sup>95</sup> Securities prices only reflect publicly available information, unless insider trading occurs.

the market incorporates the disclosed information into securities prices.<sup>96</sup> Consequently, in the United States, there is competition for access to the newest public information first, before securities prices reflect it.<sup>97</sup> The challenge for the required disclosure regime is finding the equilibrium between providing enough information that a disclosure is understood and providing too much information that it cannot be filtered and organized in a timely manner,<sup>98</sup> while also encouraging investors to participate in the markets on their own.

### B. *Information Asymmetry*

Information asymmetry exists between investors and corporate insiders,<sup>99</sup> and by extension between investors and auditors.<sup>100</sup> This aspect of the information asymmetry problem deals with the availability of information.<sup>101</sup> This “public-private divide” defines the struggle in determining how much information should remain available only to insiders and how much should be available to outsiders (i.e., the public).<sup>102</sup> Economically, this is undesirable because markets should operate with perfect information.<sup>103</sup> Mandatory disclosure reduces the cost of searching for information by making it publicly available.<sup>104</sup>

However, there is another information asymmetry divide between institutional and individual investors created because institutional investors are better able to process the available information and use it in decision making.<sup>105</sup> Individual investors lack the ability to “process and contextualize . . . information,” which creates further information asymmetry between these parties.<sup>106</sup> Even if individual investors had the ability to process this information, it would take them a significant amount of time and resources to do so, widening

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<sup>96</sup> Franco, *supra* note 92, at 250.

<sup>97</sup> Dalley, *supra* note 78, at 1094 (“[A]llowing it [information] to be distributed unevenly to selected market participants . . . would be perceived to be unfair.”).

<sup>98</sup> Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 688 (2011).

<sup>99</sup> Paredes, *supra* note 7, at 418.

<sup>100</sup> Michael Cohn, *Auditors Prepare for PCAOB Audit Reporting Changes*, ACCOUNTING TODAY (Oct. 16, 2017 5:50 PM), <https://www.accountingtoday.com/news/auditors-prepare-for-pcaob-audit-reporting-changes-with-cams>.

<sup>101</sup> Paredes, *supra* note 7, at 418.

<sup>102</sup> Zachary J. Gubler, *Reconsidering the Institutional Design of Federal Securities Regulation*, 56 WM. & MARY L. REV. 409, 411 (2014).

<sup>103</sup> Ryan Calo, *Privacy and Markets: A Love Story*, 91 NOTRE DAME L. REV. 649, 650, 654 (2015).

<sup>104</sup> Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1615 n.155 (2017).

<sup>105</sup> Calo, *supra* note 103, at 650-51.

<sup>106</sup> *Id.* at 674.

the divide between individual and institutional investors in being able to react in the market based on the information.

The remedy for information asymmetry is introducing more information,<sup>107</sup> or in the case of the federal securities laws, requiring companies to disclose more information to the public. Disclosure is positively correlated with world economic events.<sup>108</sup> The federal securities regime responds to market events that are detrimental to investors by promulgating regulations that require additional disclosures.<sup>109</sup> Nevertheless, too much information increases the risk of information overload and creates an environment for worse decision making in which investors have to “satisfice” instead of utilizing all the information available to them.<sup>110</sup>

### C. Information Overload

Overcorrection of information asymmetry leads to information overload.<sup>111</sup> Information overload is the “point where there is so much information that it is no longer possible effectively to use it.”<sup>112</sup> At this point, investors “satisfice”<sup>113</sup> and use a few attributes to draw comparisons among the available options for investment, often leaving much out of their analysis.<sup>114</sup> The issue of information overload is not specific to securities disclosure, but is also found in food and drug disclosures, mortgage disclosures, and other areas where data must be organized and assembled for consumer use.<sup>115</sup>

Due to the limitations on the human ability to process information, information overload limits the effectiveness of disclosure.<sup>116</sup> Information overload is not caused by an individual disclosure, but by the “accumulation” of disclosures, as investors must choose which disclosures to focus on.<sup>117</sup> The

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<sup>107</sup> *Id.* at 650.

<sup>108</sup> Enron, WorldComm, The Great Recession.

<sup>109</sup> See Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and The SEC*, 56 STAN. L. REV. 1, 26 (2003). See also Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 688 (2011) (“catastrophe is the most important catalyst of new regulation”).

<sup>110</sup> Paredes, *supra* note 7, at 419.

<sup>111</sup> Calo, *supra* note 103, at 651 (“[I]ntroducing more information exacerbates information asymmetry . . .”).

<sup>112</sup> Angela Edmunds & Anne Morris, *The Problem of Information Overload in Business Organisations: a Review of the Literature*, 20 INT’L J. INFO. MGMT. 17, 19 (2000) (suggesting that there is no formally accepted definition of information overload).

<sup>113</sup> Howard Latin, “Good” Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. REV. 1193, 1213 (1994).

<sup>114</sup> *Id.* at 1212; see also Choi & Pritchard, *supra* note 109, at 4.

<sup>115</sup> Ben-Shahar & Schneider, *supra* note 98, at 687.

<sup>116</sup> Choi & Pritchard, *supra* note 109, at 4.

<sup>117</sup> Ben-Shahar & Schneider, *supra* note 98, at 689.



information overload problem supports the need for specifically-targeted required disclosures, rather than relying on the assumption that “more is better.”<sup>118</sup>

The point where information is no longer usable is different for individual and institutional investors.<sup>119</sup> Institutional investors have more resources to process and analyze all the information disclosed, and perform pattern and trend analysis among industries that individual investors would not be able to do as easily or as quickly.<sup>120</sup> In other words, even if individual investors had the skills to perform this analysis,<sup>121</sup> any insight gained would likely already be included in the stock price of the publicly traded shares by the time they completed their analysis. This divide is also characterized by a cost issue — i.e., the cost associated with analyzing the overwhelming amount of information available<sup>122</sup> — as it may not be worth the time and money investment for the individual investor considering how much they have invested in the market. However, for the institutional investor, analyzing data may be worth the time and money investment due to the large amount of money in play<sup>123</sup> and the economies of scale created by the standardization of the analytical process. By focusing on individual investors, securities laws can help close this time and cost divide.<sup>124</sup>

#### D. *Characteristics of Effective Disclosure*

Disclosure can confuse investors.<sup>125</sup> Numerous scholars studied the characteristics of effective disclosure, considering the need to counteract bias and the limitations on the human ability to process information.<sup>126</sup> These characteristics must be considered as a whole, as satisfying any one of these on its own may be insufficient to make the disclosure more usable. The below characteristics are the ones this Note uses to determine AS 3101’s usability and

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<sup>118</sup> *Id.* at 650.

<sup>119</sup> Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359, 2378 (1998).

<sup>120</sup> Paredes, *supra* note 7, at 431. Due to the XBRL requirement, all public filings now use an electronic data tagging system, which increases the ability of data mining as the tags are consistent across all public filings. *See* Gerding *supra* note 8, at 1169.

<sup>121</sup> Dalley, *supra* note 7878, at 1101.

<sup>122</sup> Korsmo, *supra* note 10498, at 1615 n.155.

<sup>123</sup> Romano, *supra* note 119, at 2366 n.17.

<sup>124</sup> The time and cost divide was acknowledged by SEC Chairman Jay Clayton in a news release in which he noted, “An effective disclosure regime provides investors with the information necessary to make informed investment choices without imposing unnecessary burdens of time and money on issuers.” Ken Tysiac, *SEC Proposes Simplifying Disclosure Requirements*, *J. ACCT.* (Oct. 11, 2017), <https://www.journalofaccountancy.com/news/2017/oct/sec-proposes-simplifying-disclosure-requirements-201717645.html>.

<sup>125</sup> Choi & Pritchard, *supra* note 109, at 60.

<sup>126</sup> Talia B. Gillis, *Putting Disclosure to the Test: Toward Better Evidence-Based Policy*, 28 *LOY. CONSUMER L. REV.* 31, 47 (2015).

effectiveness. First, length; this plays a critical role in investor's ability to understand and analyze the information given<sup>127</sup> as investors may miss important information if the disclosure is too long.<sup>128</sup> Second, completeness; the disclosure must contain sufficient information, including "meaningful detail,"<sup>129</sup> for the reader to be able to interpret the disclosure correctly<sup>130</sup> and be confident that relevant information is not missing. Third, "accumulation"; in designing the disclosure, regulators must consider that it is not only the individual disclosure but all the disclosures provided that investors consider in choosing how to spend their time.<sup>131</sup> Finally, standardization; standardization of disclosures promotes consistency,<sup>132</sup> which makes it easier for investors to evaluate them and compare among companies.<sup>133</sup> Standardization of "content, format, and timing,"<sup>134</sup> such as through the use of charts, graphs or tables,<sup>135</sup> while promoting comparison among companies, prevents companies from opportunistically selecting the way in which their information is presented. The "critical audit matter" requirement of the Independent Auditor's Report has all these characteristics, and on its own would constitute an effective disclosure.

### III. THE UPDATED AUDIT OPINION IS AN EFFECTIVE DISCLOSURE THAT ADDRESSES BOTH INFORMATION ASYMMETRY AND INFORMATION OVERLOAD CONCERNS

The "Critical Audit Matter" requirement strikes a balance between information asymmetry and information overload, reaching an equilibrium amount of information for individual investors to use the information provided as a data point in their decision making. This disclosure is usable to individual investors as it helps close the gap between the time they receive the information and the time they respond to it in the marketplace.

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<sup>127</sup> Ben-Shahar & Schneider, *supra* note 98, at 687.

<sup>128</sup> Choi & Pritchard, *supra* note 109, at 61.

<sup>129</sup> Tom C.W. Lin, *A Behavioral Framework for Securities Risk*, 34 SEATTLE U. L. REV. 325, 355 (2011).

<sup>130</sup> See Ben-Shahar & Schneider, *supra* note 98 at 688.

<sup>131</sup> *Id.* at 689; see also Paredes, *supra* note 7, at 477–478 (noting that because of the length and detail of MD&A, SEC officials have suggested adding a requirement for a summary of MD&A to be included in public company financial statements).

<sup>132</sup> Lin, *supra* note 129, at 351.

<sup>133</sup> Paredes, *supra* note 7, at 475.

<sup>134</sup> Joseph A. Franco, *supra* note 92, at 296.

<sup>135</sup> Paredes, *supra* note 7, at 476.

A. *The Balancing Act between Addressing Information Asymmetry and Preventing Information Overload*

To counteract the information asymmetry and information overload problems, disclosures must provide information in a format that individual investors can directly synthesize and utilize in their decision making. Under the current system, due to the size of 10-Ks and the overwhelming and detailed information provided, individual investors must either wait for institutional investors to analyze the information and provide advice on whether to purchase or sell public shares or they must undergo the time-consuming process of reading the documents and analyzing the information themselves. In protecting individual investors, disclosures should target closing this time gap. The inclusion of CAMs in the unqualified audit opinion is a concise way of conveying to financial statements users what the auditors determined to be the most “challenging, subjective or complex”<sup>136</sup> areas of the audit, based on their knowledge about this specific company and the industry as a whole.<sup>137</sup> The new audit report is a large departure from the lack of insight on a Company’s specific audit procedures and risks under the traditional pass/fail system. Audit reports without this addition only address the information asymmetry problem on a limited basis by assuring that all required disclosures are complete and accurate.

One commentator suggested that the CAM disclosure would provide “minimal additional value” because the information is already provided in the Critical Accounting Policies section of MD&A.<sup>138</sup> However, given the lengthiness of MD&A, this likely does not counteract the information asymmetry problem because investors still must spend time searching for the required information, and they would need to possess some attributes or indicators of what information would be deemed critical to the audit to be able to thoroughly extract this information. This analysis would be time consuming and costly for individual investors. This format of presenting information helps to “level the playing field”<sup>139</sup> between institutional and individual investors. Both groups of investors will have access to the same information at the same time. There will, however, still be a time divide between individual and institutional investors as it relates to

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<sup>136</sup> Pub. Co. Acct. Oversight Bd., *supra* note 50.

<sup>137</sup> In many accounting firms, the audit practice is often further subdivided into industry specific groups, often with audit teams serving multiple clients within the same industry. This allows them to see trends and patterns that industry is facing that may not otherwise be gleaned if it were not for the consistency of teams.

<sup>138</sup> Davis Polk & Wardwell LLP, Comment Letter on PCAOB 2017-01 (Aug. 18 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228750-160786.pdf>.

<sup>139</sup> See Colleen Honigsberg et al., *Mandatory Disclosure and Individual Investors: Evidence from the JOBS Act*, 93 WASH. U. L. REV. 293, 300 (2015). Empirical studies support the notion that “institutional investors are better able to process financial disclosures than individual shareholders.” *Id.* at 303.

all other disclosures in public filings. Providing CAM information in this format will help close the time gap created when individual investors have to wait to analyze the information to incorporate it into their decision making.

B. *The Disclosure of “Critical Audit Matters” is Usable to Investors*

The disclosure of CAMs in the auditor’s report satisfies all the characteristics noted above of effective disclosure. As it relates to length, the auditor’s report is relatively short in nature, approximately one to two pages.<sup>140</sup> The addition of CAMs will not add substantial length to the auditor’s report or the 10-K. Additionally, the CAM discussion would appear under the heading “Critical Audit Matters,” and would first define “critical audit matters,”<sup>141</sup> isolating this section from the rest of the auditor’s report. The separate heading for “Critical Audit Matters” draws readers’ attention to this section and prevents investors from missing them.<sup>142</sup> This section would be short enough in comparison to the rest of the public financial statement filings that investors hopefully would be able to analyze it. The portion of the audit opinion that discusses CAMs would be complete because it would address all the items that meet the definition. Describing why the matter satisfied the CAM definition and how it was addressed in the audit further supports completeness by providing investors sufficient detail and context to interpret the other related disclosures.<sup>143</sup> Of the characteristics noted, “accumulation”<sup>144</sup> is the most difficult to attribute to this disclosure, given that it is found within the 10-K that is often over 100 pages in length.<sup>145</sup> This demonstrates why this is only a small part of updating disclosure and the financial reporting landscape requires that more disclosures are reviewed. However, provided that CAMs disclose areas that are subjective or require complex judgment, it would make sense to encourage investors to devote their time to this disclosure at the expense of other disclosures that they may be less able to analyze effectively.

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<sup>140</sup> See *supra* Introduction.

<sup>141</sup> THE AUDITOR’S REPORT OF AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.15 (Pub. Co. Accounting Oversight Bd. 2017).

<sup>142</sup> See Joseph Kimble, *Writing for Dollars, Writing to Please*, 6 SCRIBES J. LEGAL WRITING 1, 8 (1996).

<sup>143</sup> THE AUDITOR’S REPORT OF AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101 (Pub. Co. Accounting Oversight Bd. 2017).

<sup>144</sup> Ben-Shahar & Schneider, *supra* note 98, at 689. (2011).

<sup>145</sup> Cohn, *supra* note 13.

During SEC notice and comment, some commentators expressed concern that audit firms would use boilerplate language to describe the CAMs.<sup>146</sup> Even if over time these disclosures result in boilerplate language describing the risks or the procedures performed and their outcome,<sup>147</sup> this would nevertheless be beneficial in increasing standardization. The unintended standardization of these disclosures would ease the work of individual investors in comparing CAMs and the corresponding audit procedures performed.<sup>148</sup> The consistency in language would make it easier for investors to assess trends as a whole and whether the CAMs are industry specific or specific to that company. Currently, institutional investors have an advantage over individuals in trend analysis, whether based on industry, jurisdiction or other criteria, as they have teams of trained analysts to read these forms and they have computer software that can perform the analysis for them as 10-Ks contain electronic data tags based on a taxonomy used by all public requirements under the XBRL requirement.<sup>149</sup>

While all the above characteristics adequately describe the standard, over time in response to post implementation review,<sup>150</sup> commentators expect that additional guidance will be released regarding the implementation and application of this standard in practice<sup>151</sup> and make any changes as needed.<sup>152</sup>

#### IV. SIGNIFICANT RISKS SHOULD BE PRESUMED TO BE CRITICAL AUDIT MATTERS

Significant risks of material misstatement should be presumed to be “Critical Audit Matters.” This presumption is supported by the overlap in the factors considered in the identification of a “significant risk” with the qualifications to be a “Critical Audit Matter,” as well as the magnitude of the audit work performed surrounding a “significant risk.”

Significant risks “require special audit consideration”<sup>153</sup> and are required to be discussed with the audit committee,<sup>154</sup> satisfying the first prong of the

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<sup>146</sup> See Davis Polk & Wardwell LLP, *supra* note 138; see also New York City Bar Committee on Financial Reporting, *supra* note 48; Aetna, Anthem, Cigna, Humana and United Health Group, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228518-160811.pdf>.

<sup>147</sup> See PUB. COMPANY. OVERSIGHT BD., *supra* note 140, at .14 n.(c).

<sup>148</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 23.

<sup>149</sup> Gerding, *supra* note 8.

<sup>150</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 46 (expressing their expectation that the PCAOB complete a post implementation review).

<sup>151</sup> See Michael Cohn, *SEC Approves PCAOB Expanded Audit Report Standard*, ACCOUNTING TODAY (October 23, 2017), <https://www.accountingtoday.com/news/sec-approves-pcaob-expanded-auditor-reporting-model-standard>.

<sup>152</sup> *Id.*

<sup>153</sup> IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT, Auditing Standard 2110 app. A at A5 (Pub. Co. Accounting Oversight Bd. 2010).

“Critical Audit Matter” analysis. Significant risks are identified by the auditor based on the risk assessment procedures performed during the planning stage of the audit. The planning process is necessary to determine the “nature, timing, and extent” of audit procedures.<sup>155</sup> The below argument uses the example of revenue recognition, which is a “significant risk” but not the only significant risk that may be identified in an audit.

Revenue recognition is always a significant risk of material misstatement because it is a “presumed fraud risk.”<sup>156</sup> However, under this standard as written, revenue recognition would not necessarily be a “critical audit matter” unless it entailed “challenging, subjective or complex auditor judgment.”<sup>157</sup> The methodology that a company uses to recognize revenue is included in MD&A as a “critical accounting policy,”<sup>158</sup> and is crucial for investors to understand the amounts in the income statement, as well as for comparability purposes across multiple companies in the same industry.<sup>159</sup> Further, revenue can be highly complex to audit because of the risk that a company may accelerate revenue that was earned in the next year into the current year.<sup>160</sup> SEC enforcement actions involving the issue of “premature” or improper revenue recognition evidences this heightened risk.<sup>161</sup> Considering the importance of revenue to assessing the health of a company<sup>162</sup> and the high risk of misstatement, it is surprising that revenue recognition is not required to be a “Critical Audit Matter.”

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<sup>154</sup> COMMUNICATION WITH AUDIT COMMITTEES, Statement on Auditing Standards 1301.09 (Pub. Co. Accounting Oversight Bd. 2012).

<sup>155</sup> AUDIT PLANNING, Statement on Auditing Standards 2101.10(b) (Pub. Co. Accounting Oversight Bd. 2010).

<sup>156</sup> Notice of Filing of Proposed Rules, *supra* note 10, at 35400.

<sup>157</sup> *Id.*

<sup>158</sup> COMMUNICATION WITH AUDIT COMMITTEES, Statement on Auditing Standards 1301.12 (Pub. Co. Accounting Oversight Bd. 2012).

<sup>159</sup> It may be difficult to compare revenue across industries as often there are industry specific types of revenue earned that may distort the comparison between companies.

<sup>160</sup> Darin Bartholomew, *Is Silence Golden When It Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 68. Accelerating revenue is a potential risk because Form 10-K is not required to be filed until at least 60 days after the Company’s year-end. See U.S. Sec. & Exch. Comm’n, FAST ANSWERS: FORM 10-K (June 26, 2009), <https://www.sec.gov/fast-answers/answers-form10k.htm>.

<sup>161</sup> Bartholomew, *supra* note 160, at 68; see PUB. CO. ACCOUNTING OVERSIGHT BD., SEC STAFF AUDIT PRACTICE ALERT NO.12 MATTERS RELATED TO AUDITING REVENUE IN AN AUDIT OF FINANCIAL STATEMENTS 10 (Sept. 9, 2014) (expressing concern on this issue in their discussion of cutoff procedures to be performed as part of revenue recognition testing); see, e.g., Jones Day, *SEC Enforcement in Financial Reporting and Disclosure—2017 Mid-Year Update* 3 (July 2017), <http://www.jonesday.com/files/Publication/3ec4a6fd-d801-4b26-8f6f-fc2fa43adf75/Presentation/PublicationAttachment/82295301-1781-4cb8-9515-fdd30b3c64f0/SEC%20Enforcement%20in%20Financial%20Reporting.pdf>.

<sup>162</sup> Andrew Zatlin, *The Importance of Revenues and Revenue Growth*, YAHOO! (Apr. 7, 2017), <https://finance.yahoo.com/news/importance-revenues-revenue-growth-153137026.html>.

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The “Critical Audit Matters” standard is expected to undergo post-implementation review by the PCAOB with the assistance of the SEC Office of the Chief Accountant.<sup>163</sup> SEC Chairman Jay Clayton noted that post-implementation review “is an important component of high-quality regulatory decision-making.”<sup>164</sup> Furthermore, the results of the post-implementation review may lead to the issuance of additional implementation guidance on this standard.<sup>165</sup> Issuing post-implementation guidance is the seemingly logical way to add in the significant risk requirement, as both the SEC and PCAOB have already set the stage for this with their references to the need for post-implementation review and by acknowledging that revisions to the standards may need to be made. However, this change could also be accomplished by amending the standard to add in the requirement or through judicial interpretation if a CAM disclosure was challenged in court for lack of completeness. If the recommendation above of proceeding through post-implementation review is made, there is a risk of an administrative law challenge on the grounds that this change must be made through rulemaking. However, as noted below, based on the similarities between the “Significant Risk” and “Critical Audit Matter” factors, there may not be much push back from those affected because the change would likely not result in a substantial increase in the number of “Critical Audit Matters.”

#### A. *Overlapping Factors Support Similar Determinations*

The overlap in the factors for consideration in the identification of a “significant risk” and a “critical audit matter” supports the presumption that significant risks are “critical audit matters.” The use of the same words in both sets of factors would likely be interpreted to have the same meaning, providing consistency within the auditing standards as a whole.<sup>166</sup> In the SEC release which formally approved the changes to the independent auditor’s report, the SEC compared the “Critical Audit Matter” requirements with the required audit committee communications to assess the impact the final standard would have on communications between the auditor and audit committee.<sup>167</sup> This note applies

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<sup>163</sup> SEC. & EXCH. COMM’N, STATEMENT IN CONNECTION WITH THE 2017 AICPA CONFERENCE ON CURRENT SEC AND PCAOB DEVELOPMENTS (Dec. 4, 2017), <https://www.sec.gov/news/speech/bricker-2017-12-04>.

<sup>164</sup> Cohn, *supra* note 151.

<sup>165</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 46.

<sup>166</sup> Kenneth A. Bamberger, *Normative Canons in the Review of Administrative Policymaking*, 118 YALE L.J. 64, 71 (2008); *see also* James J. Brudney & Corey Ditslear, *Canons of Constructive and the Elusive Quest for Neutral Reasoning*, 58 VAND. L. REV. 1, 12-13 (2005). Courts often use the canons in interpreting the statutes in front of them as it “provide[s] stable rules of construction.” ROBERT A. KATZMANN, *JUDGING STATUTES* 50 (2014).

<sup>167</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 28.

the same methodology to examine “Significant Risks” and “Critical Audit Matters.” The below table details the factors to be considered in determining if an item is a “Significant Risk” and if an item is a “Critical Audit Matter.”



**Table 1:**<sup>168</sup>

<b>Significant Risk</b> <sup>169</sup>	<b>Critical Audit Matter</b> <sup>170</sup>
Effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements	The auditor's assessment of the risks of material misstatement, <i>including significant risks</i>
Where the risk is a fraud risk	Nature of audit evidence obtained regarding the matter
Where the risk is related to recent significant economic, accounting, or other developments	The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures
The <i>complexity</i> of transactions	Challenging, subjective or <i>complex auditor judgment</i>
The degree of <i>complexity</i> or <i>judgment</i> in the recognition or measurement of financial information related to the risk, especially those measures involving a wide range of <i>measurement uncertainty</i>	The degree of auditor judgment related to areas in the financial statements that <i>involved the application of significant judgment</i> or estimation by management, including estimates with <i>significant measurement uncertainty</i>
Whether the risk involves significant transactions with related parties	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
Whether the risk involves <i>significant unusual transactions</i>	The nature and timing of <i>significant unusual transactions</i> and the extent of the audit effort and judgment related to those transactions

<sup>168</sup> The lists in the table have been reordered from how they appear in the standards for comparison purposes. Emphasis added by the author.

<sup>169</sup> IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT, Statement on Auditing Standards 2110.71 (Pub. Co. Accounting Oversight Bd. 2010).

<sup>170</sup> THE AUDITOR'S REPORT OF AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.12 (Pub. Co. Accounting Oversight Bd. 2017).

The language of the first factor in the CAM list specifically references significant risks, which provides strong initial support for the argument that significant risks should be presumed “Critical Audit Matters.” “Significant unusual transactions,”<sup>171</sup> a factor in both analyses, must be communicated to the audit committee.<sup>172</sup> This mandatory audit committee communication satisfies the threshold question for identification as a “Critical Audit Matter.”<sup>173</sup> The significant risk guidance notes that auditors should consider the “complexity of transactions,”<sup>174</sup> which directly aligns with the “complex auditor judgment”<sup>175</sup> factor, as there is likely some complex judgment in understanding, risk assessing, and designing audit procedures surrounding a complex transaction.

The audit procedures surrounding a financial statement amount involve determining the correct unit of account for measuring the amount on the financial statements and determining which financial statement period should include the amount. The “significant risk” factor list provides that auditors should consider the “degree of . . . judgment in the recognition or measurement of financial information,”<sup>176</sup> suggesting that greater judgment would suggest a greater risk. This is similar to the “areas of financial statement that involved the application of significant judgment”<sup>177</sup> in the CAM factor list as a significant risk would likely require greater judgment. The overlap of numerous factors between the two analyses increases the likelihood that items would be identified as both.

Although there is a possibility that requiring significant risks to be “critical audit matters” might make auditors hesitant to identify a risk as significant, the responsibility that auditors have to follow the established guidance mitigates this risk. As previously noted, PCAOB inspections provide an enforcement mechanism that may result in penalties to the accounting firm if the

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<sup>171</sup> See IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT, Statement on Auditing Standards 2110.71 (Pub. Co. Accounting Oversight Bd. 2011); see also THE AUDITOR’S REPORT OF AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.12(c) (Pub. Co. Accounting Oversight Bd. 2017).

<sup>172</sup> COMMUNICATIONS WITH AUDIT COMMITTEES, Statement on Auditing Standards 1301.12(d) (Pub. Co. Accounting Oversight Bd. 2012).

<sup>173</sup> See *supra* Section I.B.

<sup>174</sup> IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT, Statement on Auditing Standards 2110.71 (Pub. Co. Accounting Oversight Bd. 2011).

<sup>175</sup> THE AUDITOR’S REPORT OF AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.11(2) (Pub. Co. Accounting Oversight Bd. 2017).

<sup>176</sup> IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT, Statement on Auditing Standards 2110.71 (Pub. Co. Accounting Oversight Bd. 2011).

<sup>177</sup> THE AUDITOR’S REPORT OF AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION, Statement on Auditing Standards 3101.12(b) (Pub. Co. Accounting Oversight Bd. 2017).

auditing standards are not followed.<sup>178</sup> Auditors are incentivized to be diligent in following the guidance regarding testing revenue recognition as this is an area that the PCAOB has often commented on and pursued enforcement action.<sup>179</sup>

B. *The Audit Procedures Required for Significant Risks Support  
“Critical Audit Matter” Factors on Audit Effort and Evidence*

Once the auditor determines that an item is a significant risk, the auditor’s substantive audit procedures (the process for testing an account balance or transaction) must be “specifically respons[ive] to the assessed risks.”<sup>180</sup> In practice, this requires further tests of details and additional selections when performing audit sampling when compared to non-significant risks.<sup>181</sup> The results of these additional procedures could be the basis for a strong and meaningful discussion of how a “Critical Audit Matter” was addressed in the audit, which is a component of the CAM disclosure.

Audit evidence includes both internal and external evidence. Internal evidence is information provided by the Company, contrasted with external evidence that is gathered from independent outside parties, such as through the confirmation process.<sup>182</sup> External evidence is considered to be more reliable, because of its source, than internal evidence and is therefore preferred when conducting audit procedures.<sup>183</sup> When testing “significant risks,” the PCAOB recommends obtaining evidence “directly from independent and knowledgeable sources outside the Company” to increase the persuasiveness and reliability.<sup>184</sup> For example, when testing revenue, an auditor would confirm the terms of a sale

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<sup>178</sup> Donna M. Nagy, *The SEC at 70: Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1016 (2005). For example, in 2012, Ernst & Young was fined \$2,000,00 in civil money penalties. Pub. Co. Accounting Oversight Bd., Order Making Findings & Imposing Sanctions, (Feb. 8, 2012), [https://pcaobus.org/Enforcement/Decisions/Documents/Ernst\\_Young.pdf](https://pcaobus.org/Enforcement/Decisions/Documents/Ernst_Young.pdf).

<sup>179</sup> See Deloitte & Touche LLP, SEC COMMENT LETTERS- INCLUDING INDUSTRY INSIGHTS xii (Nov. 2017), <https://www.iasplus.com/en-us/publications/us/sec-cl/2017?id=en-us:email:CLB2017>. In the PCAOB Staff Inspection Brief *Preview of Observations from 2017 Inspections of Auditors of Issuers*, the PCAOB explained that a common theme in the inspection results was the insufficiency of substantive audit procedures compared to the risk level. Specifically, the PCAOB noted the level of insufficiency of tests of details on revenue and the internal controls over the systems used to determine the amount of revenue recognized. Pub. Co. Accounting Oversight Bd., *Preview of Observations from 2017 Inspections of Auditors of Issuers* (Nov. 2017), <https://pcaobus.org/Inspections/Documents/inspection-brief-2017-4-issuer-results.pdf>

<sup>180</sup> THE AUDITOR’S RESPONSES TO RISKS OF MATERIAL MISSTATEMENT, Statement on Auditing Standards 2301.11 (Pub. Co. Accounting Oversight Bd. 2010).

<sup>181</sup> *Id.* at AS 2301.14.

<sup>182</sup> AUDIT EVIDENCE, Statement on Auditing Standards 1105.8 (Pub. Co. Accounting Oversight Bd. 2010).

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at 15-16.

with a purchaser<sup>185</sup> or “review the company’s contracts.”<sup>186</sup> Confirmation provides persuasive evidence because the sale was verified by a source outside the Company. The types of evidence tested as part procedures surrounding significant risks are highly persuasive, which would be considered in the CAM factor “Nature of Audit Evidence obtained.”<sup>187</sup> Confirmation demonstrates an increased “audit effort required to address the matter.”<sup>188</sup>

*C. Including Significant Risks as Critical Audit Matters is Necessary to Address Investor Information Needs*

Including significant risks as “Critical Audit Matters” aligns with investors’ desire to better understand the findings of the “extensive audit process.”<sup>189</sup> Further, this inclusion supports the goal of protecting investors by persuading readers of financial statements to focus on the areas of significant risk.<sup>190</sup> By highlighting CAMs in disclosures that are simple and complete, investors would be credibly informed of some of the risks faced by the company they are investing in.

However, the results of PCAOB inspections<sup>191</sup> of audit firms found that there have been “recurring audit deficiencies” because the audit procedures performed on “significant risks” were not “specifically responsive.”<sup>192</sup> For example, in testing revenue, the audit procedures of only inquiring of management and reviewing information provided by the Company were determined to be insufficient to test a significant risk.<sup>193</sup> Under the traditional

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<sup>185</sup> THE CONFIRMATION PROCESS, Statement on Auditing Standards 2310.08 (Pub. Co. Accounting Oversight Bd.).

<sup>186</sup> *Id.* at 7.

<sup>187</sup> *Supra* Table 1.

<sup>188</sup> *Supra* Table 1.

<sup>189</sup> 2011 Concept Release, *supra* note 38, at C-2.

<sup>190</sup> However, there is a risk that these disclosures would detract investors from considering in their investment decision additional areas of risk that did not rise to the level of a significant risk or critical audit matter that may be identified in other areas of the Annual Report.

<sup>191</sup> Firms that audit public companies are required to register with the PCAOB. As part of their registration, these firms are subject to inspection by the PCAOB of their documentation to determine if they are in compliance with the auditing standards, accounting rules, and SEC rules. PUB. CO. ACCOUNTING OVERSIGHT BD., SEC SECTION 4 INSPECTIONS RULE 4000, (Aug. 13, 2009), [https://pcaobus.org/Rules/Pages/Section\\_4.aspx](https://pcaobus.org/Rules/Pages/Section_4.aspx).

<sup>192</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF INSPECTION BRIEF: PREVIEW OF OBSERVATIONS FROM 2016 INSPECTIONS OF AUDITORS OF ISSUERS 3 (Nov. 2017), <https://pcaobus.org/Inspections/Documents/inspection-brief-2017-4-issuer-results.pdf> (referring to inadequate compliance with Auditing Standard 2301: The Auditor’s Responses to the Risks of Material Misstatement and Auditing Standard 2810: Evaluating Audit Results).

<sup>193</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., INSPECTION OBSERVATIONS RELATED TO PCAOB “RISK ASSESSMENT” AUDITING STANDARDS, NO. 8 THROUGH NO. 15 (2015), <https://pcaobus.org/Inspections/Documents/Risk-Assessment-Standards-Inspections.pdf>. Deficiencies were also

pass/fail audit model, investors had no insight into the procedures used to support the auditor's conclusion, regardless of whether they were insufficient by PCAOB standards. By including the description of the audit procedures in the CAM disclosure, the investing public would be better informed of the types of evidence obtained and procedures performed. These disclosures would enable investors to better assess the credibility of auditors' conclusions on areas of significant risk and hold auditors accountable.

## V. THE COSTS OF IMPLEMENTING THE FINAL STANDARD

Large accounting firms that perform public company audits and large law firms that represent public companies both raised cost concerns. The below discussion considers the costs that will ultimately be absorbed by the shareholders, including the cost impact if the change argued for above is approved.

In promulgating rules, agencies consider the benefits to users of the financial statements compared to the costs of implementation, even though it may be difficult to compare them.<sup>194</sup> Addressing investor information needs in a useful way is beneficial to shareholders, but is difficult to quantify.<sup>195</sup> However, the costs, including the minimal increase in audit hours, and increases in professional liability insurance premiums are easier to quantify. This is the backdrop of the below discussion on the cost of implementation.

### A. *Implementation Costs of the Standard as Approved*

A recurring concern was the increased implementation costs arising from additional audit hours, time spent by the audit committee and issuers in reviewing additional disclosures.<sup>196</sup> The SEC acknowledged the challenges in quantifying the cost of implementation because many of the costs are based on engagement-specific variables.<sup>197</sup> However, when looking at what is currently done in an audit engagement, the additional time is relatively insignificant.

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related to the time period and specific revenue accounts covered by the testing to ensure that sufficient testing was performed to cover the whole period and that revenue regardless of its balance sheet impact was tested.

<sup>194</sup> During the process of researching and drafting the proposed standards, the PCAOB weighed the benefits to investors against the cost of implementation, primarily through a qualitative analysis as these items were difficult to quantify. SEC ORDER GRANTING APPROVAL, *supra* note 45, at 34.

<sup>195</sup> *Id.* at 35.

<sup>196</sup> See Davis Polk & Wardwell LLP, *supra* note 138; see also Sullivan & Cromwell LLP, *supra* note 48.

<sup>197</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45 at 35, 37–38 (discussing cost drivers such as additional audit procedures and the bifurcation of costs between one time and recurring).

Overall audit hours are not likely to increase substantially because of the work that auditors are already required to perform. Auditors are currently required to perform risk assessments to determine the level of risk for each assertion for each account balance.<sup>198</sup> The documentation of risk assessment procedures and findings would address multiple “Critical Audit Matter” disclosure requirements.<sup>199</sup> The risk assessment work papers currently address why the item is identified as a “Critical Audit Matter,” and identify the accounts and disclosures affected by it.<sup>200</sup> Audit work papers already document the audit “procedures applied, evidence obtained and conclusions reached.”<sup>201</sup> Therefore, the source data for the disclosure would already be prepared as part of the current audit process.

Thus, the incremental increase in audit hours would primarily relate to writing and reviewing this section of the opinion,<sup>202</sup> as the information needed to compose this disclosure has historically been included in the audit file and in the prior year’s audit hours. Additionally, since all “Critical Audit Matters” were communicated to the audit committee, the incremental increase in audit committee hours would also primarily consist of the review of the new disclosure.<sup>203</sup> Since audit committees are already taking a larger role in assessing the procedures performed to determine if additional procedures need to be added to the scope of work,<sup>204</sup> the detail in the disclosure they would already be familiar with. Based on these observations, it is likely that any increase in auditor and audit committee time as a result of implementation would not be as significant as some commentators suggest.

#### B. *Small Potential Increase in Audit Fees Due to Increased Liability*

Critics and advocates disagree over whether the disclosure of “Critical Audit Matters” would increase or decrease audit firm liability and overall litigation.<sup>205</sup> A big four accounting firm that supported the changes to the

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<sup>198</sup> COMMUNICATIONS WITH AUDIT COMMITTEES, Statement on Auditing Standards 1301 (Pub. Co. Accounting Oversight Bd. 2012).

<sup>199</sup> The documentation would address whether the account is material and whether there is significant management judgment or complexity associated with the balance.

<sup>200</sup> The risk assessment guidance in the Auditing Standards provides that auditors should consider the “accounts and disclosures” in the potential misstatements that could occur in the financial statements. IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT, Statement on Auditing Standards 2110.59(a) (Pub. Co. Accounting Oversight Bd. 2010).

<sup>201</sup> Retention of Records Relevant to Audits and Reviews, Exchange Act Release No. 33-8180 (Jan. 27, 2003), <https://www.sec.gov/rules/final/33-8180.htm>.

<sup>202</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 37.

<sup>203</sup> *Id.* at 33, 35.

<sup>204</sup> *See supra* Section 1.A.

<sup>205</sup> Davis Polk & Wardwell LLP, *supra* note 48; PricewaterhouseCoopers, Comment Letter on PCAOB 2017-01, (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701->

Independent Auditor's Report expressed concern that the "discussion of critical audit matters is likely to result in an increased potential for meritless claims under the securities laws by expanding the number and variety of statements that will be attributed to the auditor."<sup>206</sup> The PCAOB agreed.<sup>207</sup> In contrast, the SEC felt that the risk of increased litigation was mitigated by auditor judgment and the materiality aspects of CAMs, which provide a framework for auditors to apply in identifying CAMs.<sup>208</sup> While any increase in insurance premiums due to additional litigation liability will likely be reflected in the cost of audits, this should not be the sole reason for withholding this information.<sup>209</sup>

Generally, increases in insurance claims are positively correlated with increases in insurance premiums.<sup>210</sup> The increasing costs of malpractice insurance will likely be passed on to the Company through the costs of audits. This is especially true in light of the fact that, historically, new securities regulations have increased the cost of audits. For example, the costs of audits rose after the passage of the Sarbanes Oxley Act, which required auditors to express an opinion on the effectiveness of internal controls.<sup>211</sup> Shareholders have expressed their interest in having this information and since they are the ones ultimately paying for audits, the benefit of addressing their needs outweighs the increase in costs.

### C. *Costs of Requiring Significant Risks to be "Critical Audit Matters"*

Considering the existing cost concern commentary, it is likely that there will be cost concerns with this proposed change to the standard. The incremental increase in costs as a result of this proposed change will be minimal, as it is likely that it will not add many additional CAMs beyond what would be reported under the standard as written.<sup>212</sup>

As for any additional CAMs that may result from this change, the additional audit committee hours would be insignificant because of the current

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2228004-160801.pdf; Nasdaq, *supra* note 64; *see also* Sec. & Exch. Comm'n, Statement on SEC Approval of the PCAOB's New Auditor's Reporting Standard (Oct. 23, 2017). *But see* Council of Institutional Investors, Comment Letter on PCAOB 2017-01 (Aug. 8, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2197606-160364.pdf>.

<sup>206</sup> PricewaterhouseCoopers, *supra* note 205.

<sup>207</sup> Notice of Filing of Proposed Rules, *supra* note 10, at 35407.

<sup>208</sup> SEC ORDER GRANTING APPROVAL, *supra* note 45, at 32.

<sup>209</sup> Deloitte & Touche LLP, Comment Letter on PCAOB Rulemaking Docket Matter No. 034 5 (Aug. 12, 2016), [https://pcaobus.org/Rulemaking/Docket034/041c\\_Deloitte.pdf](https://pcaobus.org/Rulemaking/Docket034/041c_Deloitte.pdf).

<sup>210</sup> George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 305, 309 (1997/1998).

<sup>211</sup> Jo Lynne Koehn & Stephen C. DeVecchio, Revisiting the Ripple Effects of Sarbanes-Oxley Act, THE CPA JOURNAL, May 2006. *But see* FINANCIAL EXECUTIVES RESEARCH FOUNDATION, 2016 ANNUAL AUDIT FEE SURVEY 13 (2016) (noting that the better internal controls were worth the additional expense).

<sup>212</sup> *Supra* Section III.

communication and audit procedure requirements. Significant risks are required to be discussed with the audit committee,<sup>213</sup> so the additional audit committee hours would solely represent reviewing the disclosure as discussed above. Furthermore, it is likely that auditors' hours would not increase at all given the existing level of procedures and evidence needed to audit a significant risk,<sup>214</sup> which would be the basis of the CAM disclosure. Thus, the auditors incremental recurring costs would solely represent drafting the CAM disclosure for the significant risks and discussing the disclosure with the audit committee. Considering these incremental costs in conjunction with the other costs of implementing this standard, the benefits to the investors of additional information and increased transparency will nevertheless outweigh these costs.

#### CONCLUSION

Updating the Independent Auditor's Report is an important step in simplifying disclosure to benefit individual investors and markets. The CAM disclosure makes securities markets more fair because it creates a more level playing field between institutional and individual investors. If the current pattern of reacting to market events by adding new disclosures continues, the information asymmetry and information overload problems will be exacerbated to the detriment of individual investors. The insight provided in the CAM disclosure, while the first of its kind, aligns with Congress' original intent of protecting ordinary investors through disclosure, which dates back to the 1930s. The information provided in the CAM disclosure will be a data point in individual investor decision making and close the time and costs gaps between institutional and individual investors.

The final standard, while checking off many boxes of effective disclosure, still requires continued research and commentary by both scholars and practitioners to ensure that the desired aims are achieved. As this note argues, one change that should be made is to require that significant risks be "Critical Audit Matters" to reduce the information asymmetry between investors and auditors and provide investors with greater context for the information provided in public financial statements. With the accumulation problem in mind, increasing the usability of one disclosure is not enough. There must be revision and updating of a larger number of disclosures to have a meaningful impact. Progress is not achieved overnight, but rather in small steps that cumulatively overhaul of the United States securities disclosure regime.

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<sup>213</sup> *Supra* note 164.

<sup>214</sup> *Supra* Section IV.B.