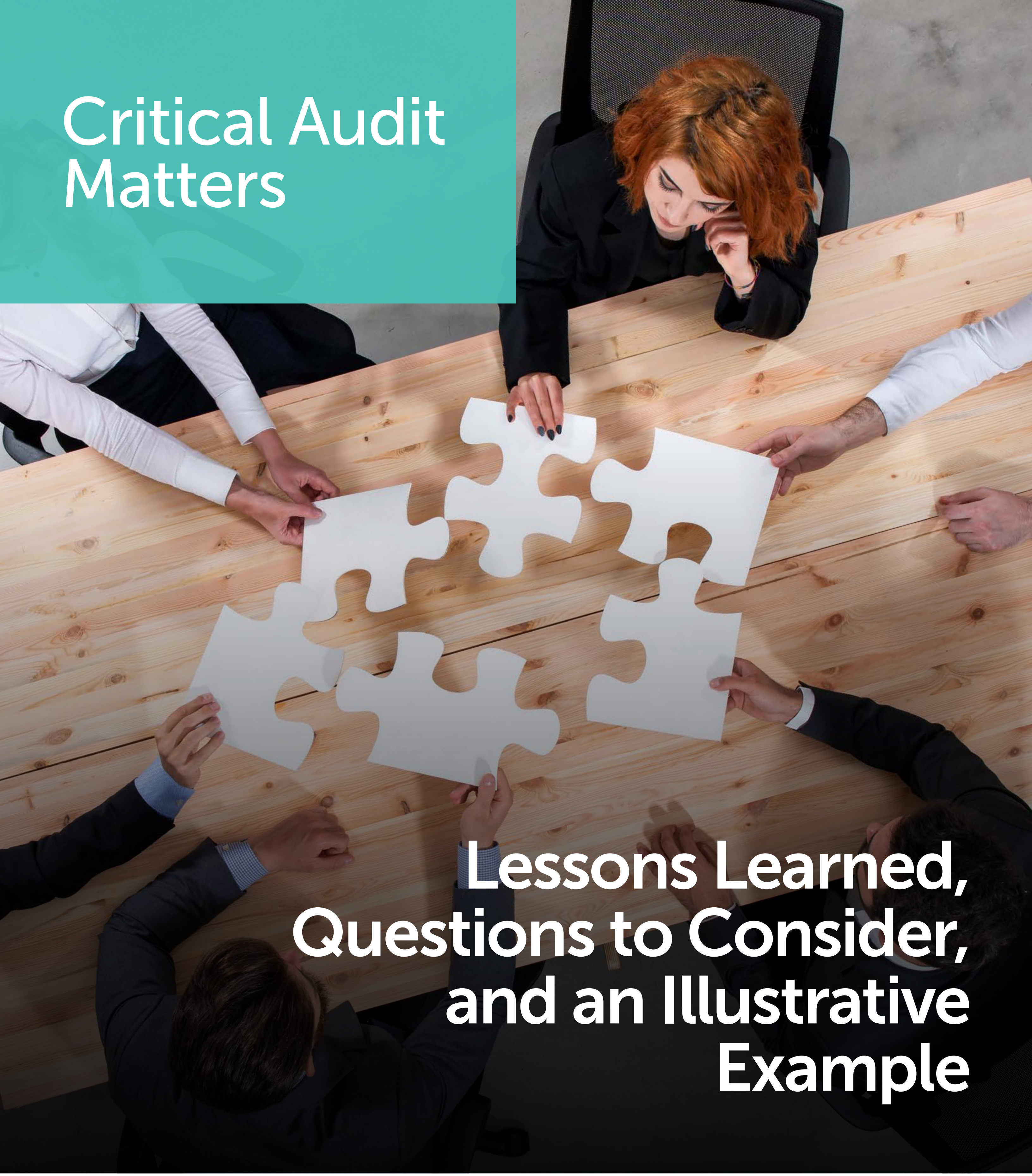
Critical Audit Matters



Lessons Learned, Questions to Consider, and an Illustrative Example

CENTER FOR AUDIT QUALITY

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Introduction

In 2019, a major change will be coming to certain auditor's reports. Starting with audits of large accelerated filers for periods ending on or after June 30, 2019, auditors will be required to communicate critical audit matters (CAMs) in their auditor's reports.

The applicable Public Company Accounting Oversight Board (PCAOB) standard defines a CAM as the following: any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee, *and* that (1) relates to accounts or disclosures that are material to the financial statements, *and*; (2) involved especially challenging, subjective, or complex auditor judgment.[1]

The determination of whether a matter is a CAM involves application of principles-based requirements, and the PCAOB standard does not specify that any matter(s) will always be a CAM. When determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account, alone or in combination, a non-exclusive list of factors specified in the standard.[2] The auditor's communication of each CAM in the auditor's report will include: (1) the identification of the CAM, (2) a description of the principal considerations that led the auditor to determine that the matter was a CAM, (3) a description of how the matter was addressed in the audit,[3] and (4) a reference to the relevant financial statement accounts or disclosures.

So, what matters are likely to be CAMs? What matters are unlikely to be CAMs? What will a CAM communication look like? This resource sheds light on these and other questions.

Continuing its longstanding, proactive, and constructive engagement on the issue of updating the auditor's report, the public company auditing profession has worked extensively to assist with implementation of the CAMs requirement. In July 2018, for example, the Center for Audit Quality (CAQ) published *Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements*.[4]

Meanwhile, public company auditing firms have begun performing "dry runs" of the CAM requirements. These dry runs entail practicing the identification and drafting of CAMs, as well as engaging with management and audit committees prior to the effective date.

This publication shares early observations from these ongoing dry runs—observations that should be valuable for audit committees, investors, auditors, and others in the financial reporting ecosystem. It also provides key questions—derived from the dry-run experiences to date—that audit committees and others should consider, along with an illustrative example of a CAM communication.

CAM Dry Runs: Early Lessons Learned

The CAM dry runs are intended to support the development and finalization of public company auditors' methodologies for determining and communicating CAMs. Importantly, they are also intended to educate and prepare management and audit committees for the communication of CAMs by the auditor. The following are some of the early lessons learned:

- **Determining which matters are CAMs involves applying a principles-based approach and significant auditor judgment**. Numerous factors influence an auditor's consideration of which matters involved especially challenging, subjective, or complex auditor judgment. The determination of CAMs will be unique to each audit.

1 See AS 3101.11.
2 See AS 3101.12a-f.
3 See AS 3101.14c
4 Available at www.thecaq.org/critical-audit-matters-key-concepts-and-faqs-audit-committees-investors-and-other-users-financial.

- **It is important for the auditor to communicate with management and the audit committee early and often in the process of identifying and drafting CAMs.** This communication can help avoid surprises about the matters that are ultimately determined to be CAMs and the information communicated in the description of the CAMs. This preparation also allows management to consider the need for modifications to the company's disclosures in relation to areas likely to be CAMs. Any modifications of a company's disclosures should be based on management's reporting requirements and should be independent of the auditor's identification of CAMs.

- **Auditors, preparers, audit committees and others should plan accordingly for the time it will take to determine and draft CAMs.** The process to determine CAMs and draft CAM communications is the auditor's responsibility. While CAMs could be identified throughout the audit, it will be important that auditors discuss draft CAM communications with management and the audit committee well in advance of when the auditor's report is to be issued to help make the process run more smoothly.

- **Drafting CAMs can be challenging.** For example, it can be difficult to strike the right balance between the CAM description in the auditor's report and information in the company's disclosures, to convey concisely the essence of why a matter is a CAM, and to describe how the CAM was addressed in the audit in a manner that is informative, but not overly technical.

CAMs: Questions for Audit Committees and Others to Consider

Based on experiences from the CAMs dry runs performed by public company auditors, the following are some questions for audit committees and others to consider when developing their understanding of the requirements to include the communication of CAMs in the auditor's report.

These questions and considerations are not meant to be all inclusive, nor are they intended to be used as a checklist. Rather, they are meant to promote a dialogue about the auditor's implementation of the CAM requirements to assist audit committees and others in enhancing their (1) understanding of the impact that the requirement to identify and communicate CAMs may have throughout the audit and (2) interactions with auditors, management, and investors.

The source of CAMs are those matters communicated or required to be communicated to the audit committee. PCAOB auditing standards already require a wide range of topics to be discussed and communicated with the audit committee, which in most cases means most, and likely all, of the matters that will be CAMs are already being discussed with the audit committee. Therefore, dialogue between the audit committee and auditor about the implementation of CAMs should be an extension of ongoing discussions.

1. **How will CAMs relate to disclosures made by management in the Form 10-K outside the financial statements?**

   Consistent with the definition in the PCAOB standard, a CAM relates to an account or disclosure that is material to the financial statements.[5] As such, there will be a relationship between the CAMs communicated in the auditor's report and the accounts or disclosures in the financial statements to which the CAMs relate. The Management's Discussion and Analysis of Financial Condition

5 The CAM could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. (see page 20 of PCAOB Release 2017-001).

and Results of Operations (MD&A) is a section of the Form 10-K that provides an overview of a company's performance, its current financial condition, critical accounting estimates, and its future projections. Information disclosed in the MD&A may relate to information in the CAM description. For example, the auditor may determine that the auditing of certain critical accounting estimates included in the financial statements (or particular assumptions associated with a critical accounting estimate) meets the definition of a CAM.

2. **Will there be a CAM for every critical accounting estimate disclosed by management?**

   This will depend on the facts and circumstances of each audit. Not every critical accounting estimate necessarily involves especially challenging, subjective, or complex auditor judgment. For example, some companies may describe legal contingencies as a critical accounting estimate. However, depending on the facts and circumstances, those contingencies will not be a CAM if they did not involve especially challenging, subjective, or complex auditor judgment.[6]

3. **Will there be a CAM related to every significant risk identified by the auditor?**

   A significant risk[7] is required to be communicated to the audit committee[8] and would likely relate to an account or disclosure that is material to the financial statements, and as such could meet part of the definition of a CAM. The PCAOB adopting release states that the standard does not provide that all matters determined to be significant risks under PCAOB standards are considered CAMs.[9] Not every significant risk may involve especially challenging, subjective, or complex auditor judgment, and therefore not every significant risk will be the subject of a related CAM. For example, improper revenue recognition is a presumed fraud risk, and all fraud risks are significant risks. If auditing revenue does not involve especially challenging, subjective, or complex auditor judgment, it is not a CAM. Alternatively, it may also be possible for a matter not identified as a significant risk to relate to a CAM.

4. **Can a significant deficiency in internal control over financial reporting (ICFR) be a CAM?**

   A significant deficiency, in and of itself, cannot be a CAM as no disclosure of the determination is required.[10] A significant deficiency could, however, be a principal consideration when determining whether the matter to which the deficiency relates is a CAM. If a significant deficiency was among the principal considerations in determining that a matter was a CAM, the auditor would describe the relevant control related deficiencies in the CAM without using the term "significant deficiency." The other auditor judgment to consider when a control deficiency exists is whether and how the auditor might need to adjust the original audit response in the area where the control deficiency has been identified.[11] However, the audit response to a control deficiency that is not a material weakness is typically less extensive because the auditor has concluded that a reasonable possibility of material misstatement due to the control deficiency does not exist. For example, the audit response may be to perform more of the same testing procedures performed prior to identification of the significant control deficiency. In those situations, judgments about the audit response would likely not be a principal consideration of why something is a CAM, and therefore would not be reported.[12] Likewise, it should not be assumed that if a CAM discusses control-related issues there was a significant deficiency related to the CAM.

5. **What matters will likely be the more common CAMs?**

   The more common CAMs likely will be in those areas involving high degrees of estimation uncertainty and that require significant

6 See pages 20-21 of PCAOB Release No. 2017-001.

7 PCAOB AS 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110), defines a significant risk as a risk of material misstatement that requires special audit consideration (AS 2110.A5). To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of the misstatement related to the risk (AS 2110.70).

8 See AS 1301.09-11.

9 See page 22 of PCAOB Release No. 2017-001.

10 See page 21 of PCAOB Release No. 2017-001.

11 See page 25 of SEC Order Granting Approval of the Proposed Rules on the Auditor's Report.

12 Ibid.

management judgment and, in turn, involve especially challenging, subjective, or complex auditor judgment. For example, auditing goodwill impairment, intangible asset impairment, business combinations, aspects of revenue recognition, income taxes, legal contingencies, and hard to fair value financial instruments are areas that could involve especially challenging, subjective, or complex auditor judgment and be a CAM. However, auditing of these accounts may not always be a CAM because auditing these accounts may not always involve especially challenging, subjective, or complex auditor judgment.

6. **How comparable will CAMs be across companies in the same industry?**

The PCAOB stated that the auditor must determine, in the context of the specific audit, that a matter involved especially challenging, subjective, or complex auditor judgment.[13] As such, CAMs should be specific to the audit of that company. However, it could be common for auditors of companies in the same industry to have similar matters that they communicate as CAMs, but the communication of the CAMs will be specific to that audit, because the auditor's assessment of the risks of material misstatement and related audit response often will vary based on a company's unique processes and controls. As a result, while the matters that are CAMs may be relatively similar among companies in the same industry, the principal considerations that led the auditor to determine a matter was a CAM and the way the matter was addressed in the audit may differ. As such, the content of the CAM communications may be different.

7. **Are CAMs similar to key audit matters?**

Key audit matters (KAMs) are required to be communicated for audits of listed entities performed in accordance with International Standards on Auditing set by the International Auditing and Assurance Standards Board (IAASB), which are used in various jurisdictions, including Europe. Both the PCAOB's and the IAASB's auditor reporting standards were adopted with the overall intent of providing users of auditor's reports with more audit-specific information. The PCAOB has stated that although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding the matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches.[14]

CAMs relate to an account or disclosure that is material to the financial statements and involved especially challenging, subjective, or complex auditor judgment. By contrast, in deciding which matters are KAMs, the IAASB standard requires auditors to first determine which matters required significant auditor attention, and then determine which of those matters were of most significance to the current period's audit, and therefore constituted KAMs.[15] KAMs may include matters relevant to the audit which are not however directly related to accounts and disclosures in the financial statements. For example, the implementation of a new information technology (IT) system during the period may be an area of significant auditor attention according to the IAASB's standard and may therefore be identified and communicated as a KAM.[16] Since the PCAOB's definition of a CAM requires that the matter relate to an account or disclosure that is material to the financial statements, the new IT system would likely not in and of itself make it a CAM.[17] However, the implementation of a new IT system during the period may be among the principal considerations that led an auditor to conclude that a matter involved especially challenging, subjective, or complex auditor judgment. As such, a new IT system implementation may be described in a

13 See page 22 of PCAOB Release No. 2017-001.

14 See page 10 of PCAOB Release No. 2017-001.

15 See ISA 701.9-10.

16 ISA 701.A18 states that "in addition to matters that relate to the specific required considerations in paragraph 9, there may be other matters communicated with those charged with governance that required significant auditor attention and that therefore may be determined to be key audit matters in accordance with paragraph 10… For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular if such a change had a significant effect on the auditor's overall audit strategy or related to a significant risk (e.g., changes to a system affecting revenue recognition)."

17 The CAM could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. (see page 20 of PCAOB Release 2017-001).

CAM communication as a principal consideration, but in the context of auditing the account(s) or disclosure(s) to which the CAM relates.

8. **Is it expected that auditors will always communicate at least one CAM in the auditor's report?**

   It is possible that an auditor will determine that there are no CAMs. However, the PCAOB has indicated that it expects that in most audits to which the requirement to communicate CAMs applies, the auditor will identify at least one CAM.[18] There may be CAMs even in an audit of a company with limited operations or activities. However, there may be circumstances in which the auditor determines there are no matters that meet the definition of a CAM and, in those circumstances, the auditor will communicate in the auditor's report that there were no CAMs.[19]

9. **What is the auditor's process for drafting the CAM section of the auditor's report, and at what point in that process should management and the audit committee expect to be involved?**

   The auditor's process for identifying CAMs and drafting the CAM section of the auditor's report will vary based on the auditor and the company being audited. Auditors, management, and audit committee members should work together to establish a process for discussing matters the auditor has determined to be CAMs and reading the drafts of the CAM section of the auditor's report, including identifying the parties who will be involved at the company. In establishing the process, consideration should be given to the timing of when the process will start, dedicating time in audit committee meetings to discuss the auditor's requirements related to CAMs, and establishing expectations for sharing and receiving drafts of the CAM section of the auditor's report. An established process should help avoid surprises in the matters identified as CAMs and the information the auditor will communicate in his or her report about those matters.

10. **How can companies prepare for questions about CAMs from investors?**

    Companies can prepare for questions about CAMs from investors by understanding the auditor's responsibilities with respect to identifying and communicating CAMs and understanding why the auditor determined particular matters to be CAMs. These matters should be in areas that auditors have already discussed with audit committee members and likely with management. Audit committee members and management should ask their auditors questions about the CAMs to fully understand why those matters involved especially challenging, subjective, or complex auditor judgment. Management may also want to identify who within the company will address any questions regarding CAMs from investors or other stakeholders.

18 See note to AS 3101.12.
19 See AS 3101.16.

Illustrative Example of a CAM

The following is an illustrative example of a CAM section of the auditor's report that highlights the required components of communicating CAMs. CAMs are intended to be unique to each audit and not generic or boilerplate. As such, this is only one example of how a CAM communication may be drafted to meet the requirements of the PCAOB standard.

ILLUSTRATIVE CRITICAL AUDIT MATTER[20]

The critical audit matter communicated below is a matter arising from the current period audit of the consolidated financial statements that was communicated or required to be communicated to the audit committee and that: (i) relates to accounts or disclosures that are material to the consolidated financial statements and (ii) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

GOODWILL IMPAIRMENT ASSESSMENT – REPORTING UNIT A

As described in Notes [x] and [y] to the consolidated financial statements, the Company's consolidated goodwill balance was $xxx million at December 31, 20X9, which is allocated to the Company's reporting units. Goodwill is tested for impairment at least annually at the reporting unit level. The determination of the fair value of the reporting units requires management to make significant estimates and assumptions related to forecasts of future revenues and operating margins and discount rates. As disclosed by management, changes in these assumptions could have a significant impact on either the fair value of the reporting units, the amount of any goodwill impairment charge, or both.

We identified the goodwill impairment assessment of *Reporting Unit A* as a critical audit matter. The Company plans to introduce a new product platform whose forecasted revenues contribute significantly to the fair value of *Reporting Unit A*. In turn, auditing management's judgments regarding forecasts of future revenue and operating margin, and the discount rate to be applied involved a high degree of subjectivity.

The primary procedures we performed to address this critical audit matter included:

- Testing the effectiveness of controls relating to management's goodwill impairment tests, including controls over the determination of the fair value of *Reporting Unit A*.
- Testing management's process for determining the fair value of *Reporting Unit A*. Due to the lack of historical experience available for the Company's new product platform, we evaluated the reasonableness of management's forecasts of future revenue and operating margin by comparing these forecasts to historical operating results for the Company's similar existing platforms.
- Utilizing a valuation specialist to assist in testing the Company's discounted cash flow model for *Reporting Unit A* and certain significant assumptions, including the discount rate.
- Evaluating whether the assumptions used were reasonable by considering the past performance of reporting units similar to *Reporting Unit A* and third-party market data, and whether such assumptions were consistent with evidence obtained in other areas of the audit.

20 Note: Please see AS 3101.15 for the required language that should precede critical audit matters communicated in the auditor's report. The first paragraph of the illustrative example has been tailored to reflect that there is only one CAM in the illustrative example.

Next Steps

As of this publication's release, many audit firms are continuing to perform dry runs. We encourage audit committees, management, investors, and other stakeholders to remain engaged in understanding what the reporting of CAMs may look like in the future. As the dry runs continue, further lessons likely will be learned. We will continue to evaluate the observations from these dry runs and look forward to future learning and dialogue on the implementation of this standard. The PCAOB, which is actively monitoring the implementation of the new requirements and proactively engaging with key stakeholders to better understand their experiences and implementation issues, will want to hear from audit committees and other stakeholders.

WE WANT TO HEAR FROM YOU

So that we can provide resources that are informative and best address the needs of our stakeholders, we would appreciate your response to three, short questions.

SHARE FEEDBACK

Survey URL: https://thecaq.qualtrics.com/jfe/form/SV_bOO1RLXJe2yOFjT

Appendix A: The Basics on CAMs

In 2017, the PCAOB adopted—and the Securities and Exchange Commission (SEC) approved—AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. The first phase of the standard was implemented for 2017 year-end reporting. The next phase of implementation relates to the requirement to communicate CAMs in the auditor's report, which will be the most significant change as a result of the standard.

The SEC believes that "communication of CAMs could enhance the value and relevance of audits to the capital markets and be useful to investors and other financial statement users in assessing a company's financial reporting and making capital allocation and voting decisions."[21]

EFFECTIVE DATE FOR COMMUNICATION OF CAMS

The effective date for the communication of CAMs is as follows:

- Audits of large accelerated filers: fiscal years ending on or after June 30, 2019
- Audits of all other companies to which the CAM requirements apply:[22] fiscal years ending on or after December 15, 2020

DETERMINING WHETHER A MATTER IS A CAM

The standard defines a CAM as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements, *and* (2) involved especially challenging, subjective, or complex auditor judgment.[23]

The determination of whether a matter is a CAM involves the application of principles-based requirements, and the standard does not specify that any matter(s) will always be a CAM. When determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account, alone or in combination, a non-exclusive list of factors specified in the standard.[24]

COMMUNICATION OF A CAM

For each CAM communicated[25] in the auditor's report, the auditor must:

- Identify the CAM;
- Describe the principal considerations that led the auditor to determine that the matter was a CAM;
- Describe how the CAM was addressed in the audit; and
- Refer to the relevant financial statement accounts or disclosures that relate to the CAM.[26]

The standard does not prescribe a specific format for describing how the matter was addressed in the audit. Consistent with the objective of providing more information about the audit, the PCAOB has explained that the CAM description should provide a useful summary, as opposed to describing every aspect of how the matter was addressed in the audit.[27]

21 See pages 12–13 of the SEC Order Granting Approval of the Proposed Rules on the Auditor's Report.
22 Communication of CAMs is not required for audits of (1) brokers and dealers reporting under Rule 17a-5 of the Securities Exchange Act of 1934 (the "Exchange Act"); (2) investment companies registered under the Investment Company Act of 1940, other than business development companies; (3) employee stock purchase, savings, and similar plans; and (4) emerging growth companies as defined in Section 3(a)(80) of the Exchange Act.
23 See AS 3101.11.
24 See AS 3101.12a-f.
25 The auditor must communicate in the auditor's report CAMs relating to the audit of the current period's financial statements, or state that the auditor determined there are no CAMs. See AS 3101.13.
26 See AS 3101.14a-d.
27 See page 31 of PCAOB Release No. 2017-001.

Appendix B: Additional Resources on the Auditor's Report and CAMs

CAQ

- *Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements* (July 2018)
- CAQ auditor reporting online resource page

PCAOB

- Staff Guidance: Changes to the Auditor's Report (August 2018)
- *Rulemaking: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (June 2017)

SEC

- Order Granting Approval of Proposed Rules on the Auditor's Report (October 2017)

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