Critical audit matters: Information for audit committees

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In June 2017 the Public Company Accounting Oversight Board (PCAOB) revised Auditing Standard (AS) 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which, together with related amendments, was approved by the SEC on October 23, 2017. This standard introduced the first significant changes to auditor reporting in decades.

AS 3101 requires the auditor's report to include information about auditor tenure and a statement that the auditor is required to be independent. Also, the standard includes some changes to the format of and verbiage used in the standard auditor's report. These provisions of AS 3101 were effective for audits of fiscal years ending on or after December 15, 2017.

More noteworthy, the standard also requires auditors to communicate critical audit matters (CAMs) in their reports on audits of financial statements. This new requirement will have substantial ramifications for auditors and the companies they audit. As a result, audit committees are asking important questions about CAMs and the process for determining and disclosing them in the auditor's report.

What are the CAM requirements of AS 3101?

A CAM is defined in AS 3101 as a matter that was communicated or required to be communicated to the audit committee and that: (a) relates to accounts or disclosures that are material to the financial statements, and (b) involved especially challenging, subjective, or complex auditor judgment. When determining whether a matter involved especially challenging, subjective or complex auditor judgment, the auditor takes into account certain factors, including the auditor's assessment of the risks of material misstatement.

Although there is no prescribed format, the communication of each CAM in the auditor's report should include:

- Identification of the CAM
- A description of the principal considerations that led the auditor to determine that the matter was a CAM
- A description of how the CAM was addressed in the audit
- Reference to the relevant financial statement accounts or disclosures

What is the effective date for the communication of CAMs?

AS 3101 applies to audits conducted under PCAOB standards. However, communication of CAMs is not required for audits of brokers and dealers; investment companies other than business development companies; employee stock purchase, savings and similar plans; or emerging growth companies.

Provisions related to CAMs will be effective for audits of fiscal years ending on or after:

- June 30, 2019 for large accelerated filers
- December 15, 2020 for all other companies to which the requirements apply

What is the process for the determination of CAMs?

Audit firms are still determining the impact of AS 3101 on their audit methodology, reporting guidelines and communications with audit committees. However, it is clear that the determination and communication of CAMs will require more time on the part of the auditor, management and the audit committee.

Although the auditor's determination of CAMs is to be based on the audit procedures already performed, substantial additional effort will be required to determine which matters are and are not CAMs and to document that determination. AS 3101 does not dictate that any particular type of audit matter would always be a critical one. The determination of a CAM is principles-based. In its adoption of AS 3101, the PCAOB commented, "The Board believes that these matters will likely be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements."

When determining whether a matter involved especially challenging, subjective or complex auditor judgment, the auditor will take into account numerous factors that are unique to each engagement. For example, due to the specific facts and circumstances involved with each critical accounting estimate, it is possible that the estimate may or may not be a CAM. Likewise, not every significant risk identified by the auditor will involve especially challenging, subjective or complex auditor judgment and therefore may not result in a CAM. And, although it may be common for audits of companies in the same industry to have similar CAM disclosures, the determination of CAMs for a specific company will be influenced by the company's unique processes and controls that affect the auditor's assessment of risks and related audit responses.

The determination of CAMs to be disclosed in the auditor's report will involve the exercise of seasoned professional judgment by the most senior professionals assigned to the engagement, such as the engagement partner and the engagement quality reviewer, and could involve others, including national office consultants.

What is the process for the communication of CAMs?

Additional time also will be incurred by experienced audit professionals in drafting the description of the CAMs for inclusion in the auditor's report. The auditor will succinctly communicate each CAM while meeting the AS 3101 requirements to describe the principal considerations that led the auditor to determine that the matter was a CAM and how the CAM was addressed in the audit.

In its order granting approval of the PCAOB's proposed rules on CAM, the SEC stated:

> "…we believe the communication of CAMs should add to the total mix of information available to investors by eliciting more information about the audit itself, which is uniquely within the perspective of the auditor, irrespective of the financial reporting responsibilities of management. Requiring communication of information about the audit, from the auditor's perspective, as the Proposed Rules require, should limit the extent to which original information would be provided by the auditor. Moreover, to the extent original information would need to be communicated in a CAM, we anticipate that the auditor, management, and the audit committee will engage in a dialogue about that communication."

We believe auditors will engage with management and the audit committee throughout the process of determining and communicating CAMs. AS 3101 drives public disclosure in the auditor's report of information that never has been disclosed. It will be important for management and the audit committee to determine whether the disclosures the auditor plans to make about the company are disclosed, as appropriate, elsewhere in the financial statements and/or MD&A in the Form 10-K, and to determine whether the company's disclosures are in need of revision as a result of the CAM disclosures. We expect management and the audit committee will spend extensive time reviewing CAMs in the draft auditor's report and in the related discussion with the auditor.

As a result of the importance and complexities of the CAM disclosures, many auditors will attempt a "practice run" of identifying, documenting and communicating CAMs a year or more in advance of the effective date for the disclosures. Some may think this will result in an over expenditure of effort, but experience has shown that the benefits of doing so outweigh the costs. It is relatively simple to talk about CAMs in theory, but it is challenging to draft the specific language that will be disclosed for the first time.

What should audit committees be thinking about in advance of the CAM disclosures?

Ramifications of the new disclosures

It is important to think through the ramifications of new CAM disclosures. Although the information the auditor provides about the company probably will be disclosed elsewhere in the Form 10-K, the auditor also will need to describe (a) the principal considerations that led the auditor to determine that a matter is a CAM and (b) a summary of how the matter was addressed in the audit. What questions will investors have about CAMs? What might the audit committee do to anticipate investor questions regarding CAMs? In answering investor questions, it will be helpful to have a deep understanding of the CAMs and the reasons they involved especially challenging, subjective or complex auditor judgment.

CAMs could result in increased focus on the auditor's report and management's related disclosures in the financial statements and MD&A. How do the CAMs disclosed in the company's auditor's report compare with those disclosed in the auditor's report of competitors? Does management plan to review the CAMs disclosed in the audit opinions on the financial statements of its competitors?

The need to prepare

The process for determining and communicating CAMs will vary based on the company being audited. However, the compression of additional work by both management and the auditor related to CAMs during the final stages of the audit may be particularly burdensome for smaller reporting companies, most of which historically need all of the time available up to the reporting deadline for financial reporting.

The audit committee should think about how the CAM requirements will affect the company's audit process, and may need to be involved with the decision of whether the auditor attempts a "practice run" of identifying, documenting and communicating CAMs in advance of the effective date for the disclosures. At a minimum, it would be prudent to ask probing questions during the planning phase of the audit engagement:

- Which existing accounting policies and practices likely would be considered CAMs as of the planning stage?
- How does the auditor intend to approach CAM identification during the audit such that the audit committee and management will be apprised as early as possible of the issues the auditor intends to disclose as CAMs?
- What is management's protocol for reviewing the company's disclosure with respect to any policies the auditor identifies as likely to be considered CAMs to ensure the disclosure is accurate and complete?

- Who at the company will be directly involved in discussing matters determined to be CAMS and reading the drafts of the CAM section of the auditor's report?
- What is the anticipated timing for review of the draft auditor's report by management and the audit committee?

A good game plan will help avoid surprises in the communication of CAMs. Ongoing dialogue among auditors, management and audit committees will be critical for the effective implementation of the requirement to disclose CAMs in the auditor's report.

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