Critical Audit Matters

Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements
Introduction

In 2017 the Public Company Accounting Oversight Board (PCAOB) adopted—and the Securities and Exchange Commission (SEC) approved—a new auditing standard: AS 3101, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (referred to hereafter as “the new standard”). The new standard significantly changes the auditor’s report. The first phase of implementation of the new standard which affects form and content of PCAOB audit reports for companies with fiscal years ending on or after December 15, 2017, is now effective.2

This publication focuses on the second phase of implementation and a new fundamental required element of the auditor’s report: the auditor’s responsibility to determine and communicate critical audit matters (CAMs). We aim to assist audit committees, investors, and other users of financial statements in understanding this new required element. The effective dates for including CAMs in the auditor’s report are as follows:

► For audits of large accelerated filers: fiscal years ending on or after June 30, 2019
► For audits of all other companies to which CAM requirements apply: fiscal years ending on or after December 15, 2020

Understanding Critical Audit Matters

The identification and communication of CAMs is the most significant change required by the new standard. This requirement is intended by the PCAOB to make the auditor’s report more informative and relevant to investors and other users of financial statements.4

At the 2017 AICPA Conference on Current SEC and PCAOB Developments, SEC Chairman Jay Clayton noted that CAMs could result in enhanced reporting, provided CAM reporting does not result in boilerplate language that lacks meaningful information specific to the audit.5

To realize the potential benefits of CAM reporting, ongoing dialogue among auditors, management, audit committees, and others will be critical both before, during, and after this second phase of implementation of the new standard.

WHAT IS A CAM?

According to the new standard, a CAM is:

► 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.6

In its release, the PCAOB indicated that matters communicated or required to be communicated to the audit committee would be the appropriate source for critical audit matters, as those matters are the most meaningful to

1 See PCAOB Release 2017-001.
3 The CAM requirements in AS 3101 do not apply to the audits of emerging growth companies, brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than business development companies, and benefit plans.
4 See page 15 of PCAOB Release 2017-001.
6 See AS 3101.11.
users of the financial statements. The phrase “arising from the audit” aligns with the terminology used in the auditing standard for communications with the audit committee, which states that one of the objectives of the auditor is to provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

The “relates to” aspect of the definition means that a matter must relate to an account or disclosure that is material to the financial statements to be a CAM. However, the matter does not necessarily need to correspond to an entire account or disclosure and therefore can be a component of an account or disclosure that is material to the financial statements.

For example, if goodwill was material to the financial statements, the auditor’s evaluation of the company’s goodwill impairment assessment could be a CAM, even if there was no impairment. The CAM would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company’s impairment policy and goodwill.

Similarly, a matter may not relate to a single account or disclosure but still could be deemed a CAM because of its pervasive effect on the financial statements. For instance, the auditor’s evaluation of the company’s ability to continue as a going concern could be a CAM, depending on other facts and circumstances of that specific audit.

Alternatively, a potential loss contingency that was communicated to the audit committee—but that was determined to be remote and was not recorded in the financial statements or otherwise disclosed—would not meet the definition of a CAM.

**HOW WILL AUDITORS DETERMINE WHETHER A MATTER IS A CAM?**

The determination of whether a matter is a CAM is principles based, and the new standard does not specify that any matter(s) would always be a CAM. When determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account certain nonexclusive factors (as specified in the new standard), such as the:

- The auditor’s assessment of the risks of material misstatement, including significant risks;
- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and
- The nature of audit evidence obtained regarding the matter.

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7 See AS 3101.12.
8 See page 16 of PCAOB Release 2017-001.
9 See page 17 of PCAOB Release 2016-003.
10 See AS 1301.03d.
11 See page 20 of PCAOB Release 2017-001.
12 Ibid.
13 Ibid.
14 See pages 20 and 21 of PCAOB Release 2017-001.
15 See AS 3101.12a–f.
auditor’s assessment of the risks of material misstatement, including significant risks.

For example, the new standard does not provide that a matter determined to be a significant risk would always constitute a CAM. Some significant risks may be CAMs, but not every significant risk will involve especially challenging, subjective, or complex auditor judgment.16

Similarly, the new standard does not require that matters such as material related party transactions or those involving the application of significant judgment or estimation by management always be a CAM.17

CAM Reporting in the Auditor’s Report

INTRODUCTORY LANGUAGE

The new standard requires introductory language to be included in the CAM section of the auditor’s report.18 This introductory language is intended to explain that CAMs do not alter the opinion on the financial statements taken as a whole and that the auditor is not providing a separate opinion on the CAMs.19

The new standard requires the following introductory language to be included in the CAM section of the auditor’s report, preceding the CAMs communicated:

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.20

CAM COMMUNICATION

Under the new standard, for each CAM communicated in the auditor’s report the auditor must:

► Identify the CAM;

► Describe the principal considerations that led the auditor to determine that the matter is 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.21

Consistent with the objective of providing more information about the audit, the new standard requires the auditor to describe how the CAM was addressed in the audit.22 While the new standard does not prescribe a specific approach for complying with this communication requirement, its objective is to provide a useful summary, as opposed to describing every aspect of how the matter was addressed in the audit or implying a separate opinion on the matter.23 The description should help financial statement users better understand these matters in relation to the audit of the financial statements.

16 See page 22 of PCAOB Release 2017-001.
17 Ibid.
18 See AS 3101.15.
19 See page 28 of PCAOB Release 2017-001.
20 See AS 3101.15.
21 See AS 3101.14a-d.
22 See AS 3101.14c
In describing how the CAM was addressed in the audit, the auditor may describe:

► the auditor’s response or approach that was most relevant to the matter;
► a brief overview of the audit procedures performed;
► an indication of the outcome of the audit procedures; and
► key observations with respect to the matter, or some combination of these elements.24

Expanded Auditor Reporting Outside the United States

REPORTING OF KEY AUDIT MATTERS (KAMs) OUTSIDE OF THE UNITED STATES

The form and content of the auditor’s report have also undergone changes outside of the United States. The International Auditing and Assurance Standards Board (IAASB), the European Union, and the Financial Reporting Council have all adopted requirements that expanded auditor’s reports.

EARLY EXPERIENCES WITH KAMs IN OTHER JURISDICTIONS

The IAASB’s changes to the auditor’s reporting standards became applicable starting with December 2016 year-end audits in many jurisdictions. The Association of Chartered Certified Accountants (ACCA) published a report on the first year of implementation of the IAASB’s expanded auditor reporting standards.25 The ACCA’s report was the result of analysis performed on 560 auditor’s reports across 11 different countries as well as roundtables with auditors, preparers, audit committee members, investors, and regulators. The ACCA report states the research revealed the following additional benefits of KAMs to the financial reporting process:26

► KAMs encourage better conversations between the auditor and those charged with governance which in turn contributes to better governance;
► KAMs help the auditor to focus on the areas of the audit requiring the most careful judgement which in turn contributes to higher audit quality; and
► KAMs give preparers incentives for revisiting financial reporting and disclosures in areas related to those KAMs which in turn leads to better financial reporting, and in turn contributes to higher quality financial reporting.27

COMPARING CAMs/ KAMs

Both the PCAOB and IAASB auditor reporting standards were adopted with the overall intent of providing users of auditor’s reports with more audit-specific information. In the Appendix we have compared the underlying requirements of the PCAOB/IAASB standards for CAMs/KAMs. The PCAOB has stated, although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding 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.28

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24 See the note to AS 3101.14c.
25 See ACCA, Key Audit Matters: Unlocking the Secrets of the Audit, March 2018.
26 Ibid.
27 Ibid.
FREQUENTLY ASKED QUESTIONS ABOUT CAMs

Audit committee members and others have expressed common initial questions and/or concerns regarding the communication of CAMs in the auditor’s report, including the following:

1. What impact will CAMs have on the communication between the auditor and audit committee?

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. However, not every topic that is discussed with the audit committee will rise to the level of a CAM. The PCAOB Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing.29

2. Could a significant deficiency in internal control be a CAM?

The determination that there is a significant deficiency in internal control over financial reporting cannot be a CAM because such determination in and of itself is not related to an account or disclosure.30 However, a significant deficiency could be among the principal considerations that led the auditor to determine a matter is a CAM. For example, if a significant deficiency was among the principal considerations in determining that revenue recognition was a CAM, then the auditor could describe the relevant control-related issues over revenue recognition in the broader context of the CAM without using the term significant deficiency.31

3. What types of matters will rise to the level of CAM?

CAMs may often relate to the significant risk areas of the audit. However, it is important to note that all significant risks may not be CAMs, as not every significant risk involves especially challenging, subjective, or complex auditor judgment. Likewise, the PCAOB standard does not limit the population of potential CAMs to significant risks, as several other factors (as described previously) are taken into consideration in identifying CAMs.

4. Will CAMs only relate to the current audit period?

The PCAOB requires the communication of CAMs identified in the current audit period. While most companies’ financial statements are presented on a comparative basis, requiring auditors to communicate CAMs for the current period, rather than for all periods presented, will provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users will be able to look at prior years’ filings to analyze CAMs over time; however, the standard permits the auditor to choose to include CAMs for prior periods.32

5. Will the auditor be the original source of information about the company in the auditor’s CAM communication?

The new standard includes a note explaining that the auditor is not expected to provide information about the company that has not been made publicly available by the company, unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the matter was addressed in the audit.33 The SEC stated that they believe that situations where auditors would be required to provide information about the company that management has not already made public would be exceptions, arising only in limited circumstances, and not a pervasive occurrence.34

6. What impact are CAMs expected to have on financial reporting?

Increased attention on CAMs could result in an incremental focus on aspects of management’s related disclosures. This could result in discussion between and among management, the audit committee, and the auditor on how CAMs are described, and that may have an impact on management’s consideration of the

29 See page 18 of PCAOB Release 2017-001.
30 See page 21 of PCAOB Release 2017-001.
31 See page 35 of PCAOB Release 2017-001.
33 See Note 2 to AS 3101.14.
34 See page 25 of the SEC’s 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, andRelated Amendments to Auditing Standards (October 23, 2017).
information to disclose in the financial statements related to that particular matter. Early dialogue among auditors, management, and the audit committee will be important.

7. How many matters will likely be CAMs?

The number of matters that are reported as CAMs will depend on factors such as the complexity of the company’s financial reporting and the audit. The requirements of the new standard note that it is expected that in most audits, the auditor would determine at least one matter involved especially challenging, subjective, or complex auditor judgment.35

8. When may the introductory language for CAMs be different than what is illustrated on page 3?

The introductory language illustrated on page 3 should be modified to indicate the periods to which CAMs relate if the auditor communicates CAMs for prior periods.36 Also, in situations in which the auditor determines there are no CAMs,37 the auditor would replace the illustrated language on page 3 with the language illustrated below.

**Critical Audit Matters**

Critical audit matters are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.38

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**What’s Next?**

Although this publication is intended as a first step in raising awareness about the underlying requirements of CAMs, it is only the beginning of the dialogue. As of this publication’s release, implementation of the CAM requirements is in its early days; many audit firms are performing dry runs. The dry runs are intended to both support the development and finalization of their methodology for determining and communicating CAMs, and engage management and audit committees in the dialogue regarding the determination and communication of CAMs. In addition, the PCAOB has committed to performing post-implementation reviews of the new standard. We encourage audit committees and other stakeholders to remain engaged in understanding what the reporting of CAMs may look like in the future.

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35 See the note to PCAOB AS 3101.12.
36 See the note in AS 3101.15.
37 AS 3101.12 states that it is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.
38 See AS 3101.16.
# Appendix: Comparing PCAOB and IAASB Auditor Reporting Standards

## Definition of a CAM/KAM

Both the PCAOB and IAASB standards require CAMs/KAMs to be selected from matters communicated to audit committees or those charged with governance. As defined, CAMs must relate to accounts or disclosures that are material to the financial statements. The application guidance in paragraph A29 of International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* (ISA 701), outlines other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter. These considerations include the importance of the matter to the intended users’ understanding of the financial statements as a whole and, in particular, its materiality to the financial statements.

<table>
<thead>
<tr>
<th>PCAOB Standard</th>
<th>IAASB Standard</th>
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</thead>
<tbody>
<tr>
<td><strong>Critical Audit Matter:</strong></td>
<td><strong>Key Audit Matters:</strong></td>
</tr>
<tr>
<td>Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that</td>
<td>Key audit matters are those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period.</td>
</tr>
<tr>
<td>► relates to accounts or disclosures that are material to the financial statements, and</td>
<td>Key audit matters are selected from matters communicated with those charged with governance.</td>
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<td>► involved especially challenging, subjective, or complex auditor judgment.</td>
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Critical Audit Matters
DETERMINING WHETHER A MATTER IS A CAM/KAM

A CAM is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment. The PCAOB standard provides a non-exclusive list of six factors for the auditor to consider when determining if a matter involved especially challenging, subjective, or complex auditor judgment. ISA 701 includes a judgment-based decision-making framework to help auditors determine which matters are KAMs. In addition, the PCAOB and IAASB standards state the following regarding determining CAMs and KAMs:

<table>
<thead>
<tr>
<th>PCAOB Standard</th>
<th>IAASB Standard39</th>
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<tr>
<td>In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors as well as other factors specific to the audit:</td>
<td>The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:</td>
</tr>
<tr>
<td>(a) The auditor’s assessment of the risks of material misstatement, including significant risks</td>
<td>(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised)40</td>
</tr>
<tr>
<td>(b) The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty</td>
<td>(b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty</td>
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<tr>
<td>(c) The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions</td>
<td>(c) The effect on the audit of significant events or transactions that occurred during the period. (Paragraph 9 of ISA 701)</td>
</tr>
<tr>
<td>(d) The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures</td>
<td>The auditor shall determine which of the matters determined in accordance with paragraph 9 were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters. (Paragraph 10 of ISA 701)</td>
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<tr>
<td>(e) 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</td>
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<tr>
<td>(f) The nature of audit evidence obtained regarding the matter</td>
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Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. (Paragraph 12 of AS 3101)

39 The application guidance in ISA 701 (paragraphs A9 through A30) also introduces concepts and factors to consider when determining if a matter is a KAM.
40 ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
DESCRIPTION OF A CAM/KAM

The description of a CAM/KAM according to both the PCAOB and IAASB standards should avoid boilerplate language. The description should provide entity- and audit-specific information on that matter but limit the use of highly technical accounting and auditing terms. Introductory language is required to be included under both the PCAOB and the IAASB approaches to explain that the CAM/KAM communications are not providing piecemeal opinions on separate elements of the financial statements.

<table>
<thead>
<tr>
<th>PCAOB Standard</th>
<th>IAASB Standard(^{41})</th>
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<tbody>
<tr>
<td>For each critical audit matter communicated in the auditor’s report, the auditor must</td>
<td>The description of each key audit matter in the Key Audit Matters section of the auditor’s report shall include a reference to the related disclosures, if any, in the financial statements and shall address:</td>
</tr>
<tr>
<td>► identify the critical audit matter,</td>
<td>► why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and</td>
</tr>
<tr>
<td>► describe the principal considerations that led the auditor to determine that the matter is a critical audit matter,</td>
<td>► how the matter was addressed in the audit.</td>
</tr>
<tr>
<td>► describe how the critical audit matter was addressed in the audit, and</td>
<td>(Paragraph 13 of ISA 701)</td>
</tr>
<tr>
<td>► refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.</td>
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(Paragraph 14 of AS 3101)

Note: In describing how the critical audit matter was addressed in the audit, the auditor may describe (1) the auditor’s response or approach that was most relevant to the matter, (2) a brief overview of the audit procedures performed, (3) an indication of the outcome of the audit procedures, and (4) key observations with respect to the matter, or some combination of these elements.

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\(^{41}\) Also see the IAASB’s application guidance in ISA 701.A46, which notes that the auditor may describe the following in a KAM: aspects of the auditor’s response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement; a brief overview of the procedures performed; an indication of the outcome of the auditor’s procedures; or key observations with respect to the matter, or some combination of these elements.