

Critical Audit Matters: What You Need to Know About the New Auditor's Communication Requirement

Monday, April 1, 2019



CENTER
FOR AUDIT
QUALITY

CPE Credits

Today's replay is not eligible for CPE credits. Please visit www.thecaq.org for updates on future CPE eligible live webcasts.

This program qualifies for 1.5 CPE credits
Field of study: Audit

Goals of today's program

Provide an understanding as to:

- The PCAOB's requirements for the auditor to determine and communicate critical audit matters (CAMs)
- Investors' potential use of CAMs
- The preparation for implementation of CAMs currently being undertaken by audit firms, audit committees, and others
- Some frequently asked questions about CAMs

Panelists

Wes Bricker | Chief Accountant | U.S. Securities and Exchange Commission

Todd Castagno | Executive Director | Morgan Stanley

David Kane | Americas Vice Chair – Professional Practice | Ernst & Young LLP

Leslie Seidman | Independent Corporate Director

Megan Zietsman | Chief Auditor and Director of Professional Standards | Public Company Accounting Oversight Board

Moderator

Cindy Fornelli | Executive Director | Center for Audit Quality

What are Critical Audit Matters (CAMs)?

Definition of a CAM

A matter arising from the audit of financial statements that:



was communicated or required to be communicated to the audit committee

AND



relates to accounts or disclosures that are material to the financial statements

AND



involved especially challenging, subjective, or complex auditor judgment

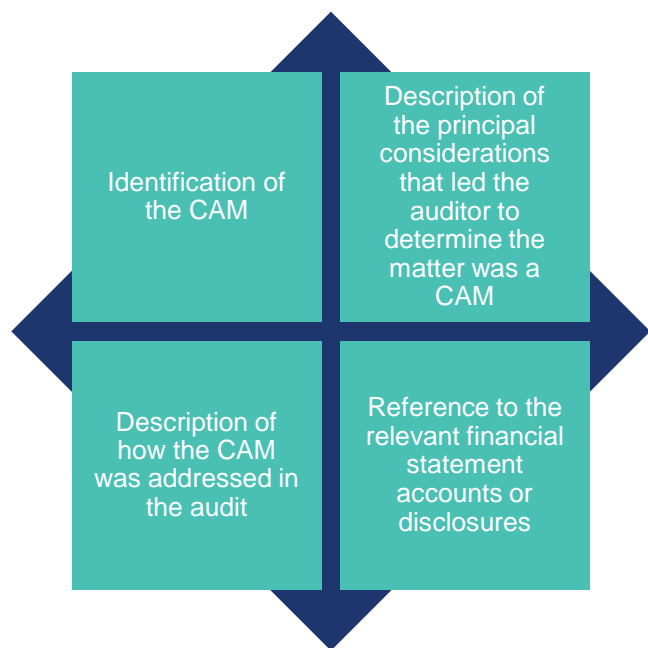
Provisions related to CAMs will be effective for audits for fiscal years:

- ending on or after June 30, 2019 for large accelerated filers
- ending on or after December 15, 2020 for all other audits to which CAM reporting applies¹

¹ 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.

What will auditors communicate about CAMs?

The communication of each CAM in the auditor's report will include:



- A new “Critical Audit Matters” section with introductory language for context
- A statement that there are no CAMs, if the auditor makes that determination

Monitoring implementation of CAMs

- The **identification and communication of CAMs is a significant change** to the auditor's report
- Auditors and others have expressed to the SEC the **importance of monitoring the implementation** of this significant change to the auditor's report
- The **PCAOB stated** in their release accompanying the adoption of the proposed rules their **intent to monitor implementation**
- The SEC stated in their approval order of the proposed rules that they **supported the PCAOB** in taking steps to monitor implementation

- **How have the PCAOB and SEC been monitoring implementation of CAMs?**

How will investors use CAMs?

- CAMs are the auditor's views and not those of management
- CAMs are an opportunity for investors to gain insights directly from the auditor
- Investors should be able to use CAMs to learn what “kept the auditor up at night”
- CAMs could enable investors to ask more pointed questions about those matters to which the CAMs relate
- CAMs are not bad or negative

How are auditors preparing for CAMs?

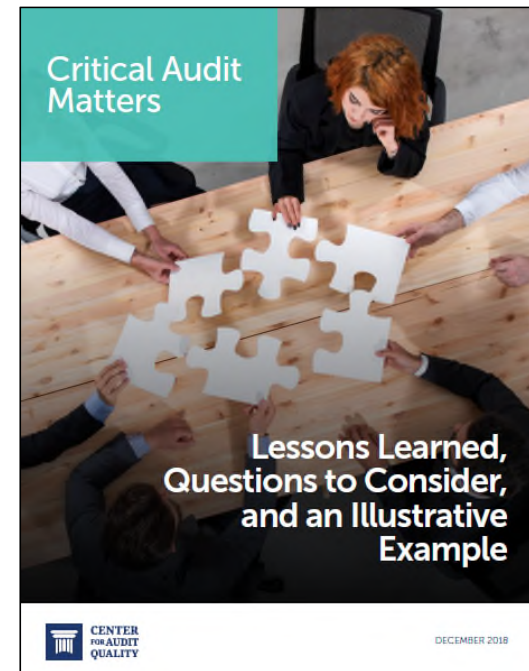
- Conducting dry runs of the CAM requirements. The purpose of the dry runs is to:
 - Understand how CAMs will develop
 - Understand the affect CAMs may have on the financial reporting process
 - Enable communications with stakeholders
- Engaging with audit committees and others to share lessons learned from the dry runs to avoid surprises when the CAM requirements become effective

How can audit committees prepare for CAMs?

- Since CAMs are a significant development for audit committees, they should consider:
 - Discussing the process for determining CAMs with the auditors
 - Seeking out opportunities to educate one another about the CAMs requirement
 - Thinking about how investors may use CAMs
 - Preparing company management and investor relations for questions from investors on CAMs

What are some lessons learned from the CAM dry runs?

- Determining which matters are CAMs involves applying a principles-based approach and significant auditor judgment
- The determination of CAMs will be unique to each audit
- Early and frequent communication from the auditor to management and the audit committee will be critical
- Drafting CAMs that convey concisely why a matter is a CAM and how the CAM was addressed in the audit in a way that is informative, but not overly technical, will take time



Example of a CAM communication

- The [CAQ's recent publication on CAMs](#) includes an illustrative example of a CAM section of the auditor's report.
- CAMs are intended to be unique to each audit.
- This is only one example of how a CAM communication may be drafted to meet the requirements of the PCAOB standard
- This example highlights the components of communicating CAMs.

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 MATTER²²

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.

²² Note: Phrases are AD 3101.12 for the required language that should promote critical audit matters communicated in the auditor's report. The full paragraph of the illustrative example has been omitted to reflect that there is only one CAM in the illustrative example.

PCAOB staff guidance on CAMs

[Implementation of Critical Audit Matters: The Basics](#) – A high-level overview of the requirements that may be of interest to audit firms, preparers, audit committees and investors



[Implementation of Critical Audit Matters: Staff Observations from Review of Audit Methodologies](#) – A summary of observations from reviews the PCAOB's Office of the Chief Auditor performed of 10 US audit firms' CAMs methodologies

[Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs](#) – Provides the staff's observations about the guidance and answers frequently asked questions about how to determine CAMs

Frequently asked questions on CAMs

- How will CAMs relate to disclosures made by management?
- Will there be a CAM for every critical accounting estimate?
- Can a significant deficiency in ICFR be a CAM? How about a material weakness or a cybersecurity breach?
- How comparable will CAMs be across companies in the same industry?
- Do you think audit committees have an expectation that CAMs be consistent across companies in the same industry?
- To whom do you think investors will go to with questions on CAMs?
- Do you think audit committees or company management have an expectation on the number of CAMs in an auditor's report?
- Are CAMs similar to the IAASB's requirement for auditors to communicate key audit matters in their auditor's report?

Questions and Answers

Key takeaways

- Keep up the momentum
- Communicate and educate
- Maintain focus on the objective of CAM reporting
- CAMs should not be a surprise
- The requirements are principles based

We value your feedback...

- **Please** take our brief [webcast survey](#)
- Visit www.thecaq.org for additional resources and information

CPE certificate

Today's replay is not eligible for CPE credits. Please visit www.thecaq.org for updates on future CPE eligible live webcasts.

As a reminder, you may access your CPE certificate by clicking the orange CPE icon if you have fulfilled the attendance check requirements.

If you do not have an opportunity to obtain your CPE certificate during today's presentation, you may obtain your certificate after 24 hours by logging back into the event and clicking the orange CPE icon.

Please note that you will not be able to respond to the attendance checks in the archive, and you must fulfill the attendance requirements during the actual presentation to receive your CPE certificate.

Additional resources

CAQ

- Publication - [Critical Audit Matters: Lessons Learned, Questions to Consider, and an Illustrative Example](#)
- Video - [Critical Audit Matters: Audit Committee Perspectives](#)
- Video - [New Auditor's Reporting Model: What Audit Committees Should Know](#)

PCAOB

- [Implementation of Critical Audit Matters: The Basics](#)
- [Implementation of Critical Audit Matters: Staff Observations from Review of Audit Methodologies](#)
- [Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs](#)



THECAQ.ORG

CENTER FOR AUDIT QUALITY