



CAO
CENTER FOR
AUDIT QUALITY

Critical Audit Matters: A Year in Review

December 2020

About the Center for Audit Quality

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

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Introduction

In 2019,¹ auditors began communicating critical audit matters (CAMs) in their auditor's reports.² The Public Company Accounting Oversight Board (PCAOB) 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.³ With these new PCAOB requirements, auditors now communicate in their auditor's report information about those areas of the audit that involved especially challenging, subjective, or complex auditor judgment.

There were over 2,000 large accelerated filers for the 2019 reporting cycle.⁴ With the first phase of CAM implementation complete, all large

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1 Provisions related to critical audit matters took effect for audits for fiscal years ending on or after June 30, 2019, for large accelerated filers, and will take effect for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

2 For more information on how CAMs are determined, please see PCAOB AS 3101: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

3 See AS 3101.11.

4 Audit Analytics: *Who Audits Public Companies – 2020 Edition*

accelerated filers have had the opportunity to issue financial statements with auditor's reports containing CAMs. This publication presents observations from the CAQ's analysis of the CAMs communicated in the auditor's reports for companies broadly, as well as a deeper dive into the S&P 100, which comprises 100 public companies across multiple industry groups.⁵ Our observations demonstrate the impact the public company audit profession has had on providing investors and others more information about the

audit by complying with the new requirements. The auditor's reports we reviewed provide straightforward descriptions about those matters that involved especially challenging, subjective, or complex auditor judgment. Within the audit procedures listed in the CAM communications, auditors provided insights into the auditing of the matter that was a CAM and a description the audit procedures performed to get comfortable with the matter. The result is an increase in the total mix of information available to investors. •



Early trends in CAMs

It is important to remember that the auditor's assessment of the risks of material misstatement and related audit response vary based on a company's unique processes and controls. While CAMs are specific to each audit, auditors of companies in the same industry could identify and communicate similar matters as CAMs. However, 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 differs.

HOW MANY CAMS WERE COMMUNICATED?

Within the S&P 100, every auditor's report in the population contained at least one CAM. There were 198 total CAMs in the population, for an average of just under two (1.98) CAMs per report. There was a single auditor's report that communicated five CAMs, while 32 auditor's reports communicated only one CAM.

APPROACH TO CAM COMMUNICATIONS

Auditors approached and organized their CAM communications in different ways. For example,

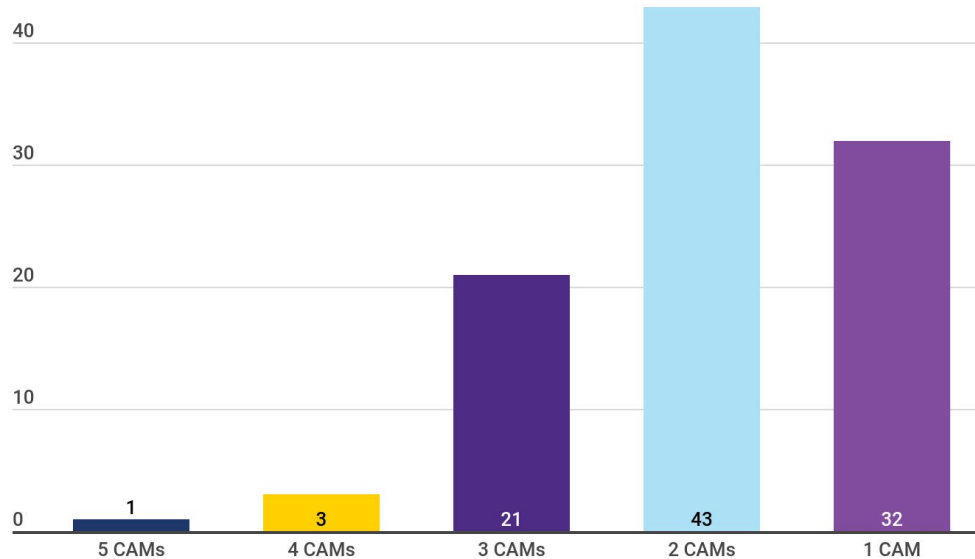
some auditors used bullets and headings while others organized the components of the CAM communication in paragraph form. Regardless of style, we were able to navigate through each required element of the CAM communication in auditor's reports for S&P 100 companies to understand the following:

- + what matters were determined to be a CAM;
- + the principal considerations that led the auditor to determine that the matter was a CAM;
- + how the CAM was addressed in the audit; and
- + the relevant financial statement accounts or disclosures that related to the CAM.

WHAT WERE SOME OF THE PRINCIPAL CONSIDERATIONS FOR MATTERS BEING A CAM?

In the auditor's reports we analyzed for companies in the S&P 100, one common driver for matters being a CAM appeared to include a high degree of judgment by management related to the matter that

Number of CAMs per Auditor's Report



led to a high degree of auditor judgment to assess or evaluate management's conclusions. Some CAM communications also described the audit effort and involvement of professionals with specialized skills and knowledge as principal considerations for the matter being a CAM.

HOW WERE CAMS ADDRESSED IN THE AUDIT?

To describe how CAMs were addressed in the audit, we observed that auditor's reports for S&P 100 companies included the following:

- + a description of the auditor's response or approach that was most relevant to the matter;
- + a brief overview of the audit procedures performed; or
- + some combination of both.

Auditors had different approaches to how they organized and described this information. The auditor's description of the procedures or audit response most relevant to the CAM was specific to

each audit. For example, we observed that auditors described that how they addressed the CAM in the following ways:

- + describing the internal controls tested;
- + identifying specific audit procedures performed;
- + communicating the evidence evaluated; and
- + noting the use of personnel with specialized skills and knowledge.

This level of transparency allows users to understand more about the areas of greater risk and how the auditors developed their testing approaches to audit those areas.

The PCAOB standard states that language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for CAMs or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a CAM should not imply that the auditor is providing a separate opinion on the CAM or on the accounts or disclosures to which they relate.⁶

⁶ AS 3101.14, Note 1

None of the auditor’s reports for companies in the S&P 100 population described how the matter was addressed in the audit by including an indication of the outcome of the audit procedures.

WHAT WERE THE MOST COMMON CAMS?

Of the 198 CAMs identified within auditor’s reports in the S&P 100, there were four common categories of CAMs: taxes (32 CAMs), goodwill and/or intangibles (28 CAMs), contingent liabilities (23 CAMs), and revenue (18 CAMs).

It is not surprising that matters in these categories could meet the definition of a CAM. Accounts and disclosures in these four areas are typically material to the financial statements, are matters that would be communicated or required to be communicated to the audit committee, and are matters that often involve a high degree of management judgment, which could in turn involve especially challenging, subjective, or complex auditor judgment.

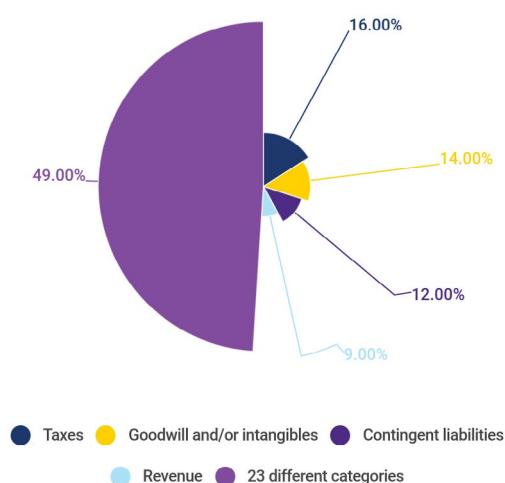
Fifty-one percent of the CAMs in the auditor’s reports for companies in the S&P 100 were in these four common categories of CAMs. The remaining 49 percent of the CAMs were spread across 23 different categories that were less prominent from a trend perspective. This demonstrates the uniqueness of CAMs to each individual audit. Business combinations, sales returns and allowances, pensions and other post-employment benefits, and asset retirement and environmental obligations were all topics that auditors of companies in the S&P 100 identified as CAMs.

Tax CAMs

Taxes were the most prevalent CAM topic within the auditor’s reports for companies in the S&P 100, with 32 total CAMs on the topic. Tax account balances and disclosures are frequently material to the financial statements and reflect management estimates involving higher estimation uncertainty. In turn, it is not surprising that this audit area would involve especially challenging, subjective, or complex auditor judgment.

We observed tax CAMs that identified various judgmental taxation areas such as the impact of new federal tax laws (e.g., the Tax Cuts and Jobs

CAM Topics as Percentage of all CAMs



Act of 2017), deferred tax assets, unrecognized tax benefits, and accounting for income taxes in general.

Goodwill and intangibles CAMs

Goodwill and indefinite lived intangible asset balances are often accounts that are material to the financial statements and that involve significant judgment by management, which could in turn involve a high degree of auditor judgment. As a result, it was not surprising to see that there were 28 CAMs related to goodwill and/or intangible assets in the S&P 100, making it the second most prevalent CAM topic. Drilling down on these 28 CAMs, eight related to intangibles, 13 related to impairment of goodwill, and seven related to both goodwill and intangibles. There were two auditor’s reports in the S&P 100 wherein the auditor communicated one CAM for goodwill and one CAM for intangibles, and there were seven auditor’s reports wherein the auditor communicated one CAM that related to both goodwill and intangibles.

The CAMs in this area reflected the complexity, subjectivity, and judgment involved in the auditor’s evaluation of management’s impairment test of the balances of goodwill and/or indefinite lived intangible assets in the financial statements. This reflects the provisions of the standard that state

that a CAM can be related to a material account or disclosure or a component of a material account or disclosure. The auditor's description of the principal considerations for why these matters were determined to be CAMs often noted the different assumptions, reporting units, or intangible assets that involved a high degree of auditor judgment and effort.

Contingent liability CAMs

In total, 23 CAMs related to contingent liabilities. The amount recorded for contingent liabilities, such as legal contingencies (estimating the outcome of a legal dispute), represent management's best estimate of what is going to happen in a future event and inherently require judgment. Management's development of contingency balances and the subsequent auditing of these judgments requires both management and auditors to consider multiple potential outcomes and identify the most likely outcome. Energy and manufacturing companies can be confronted with changing regulatory landscapes that can impact future aspects of their businesses. While legal and regulatory contingencies are the most common type of CAM, with 18 in total, there were four insurance-related liability CAMs such as self-insurance programs, and one CAM for contingent interest and penalties related to international tax positions. In this category, one-third of the CAMs specifically acknowledged the auditor's use of specialists.

Revenue CAMs

There were 18 revenue CAMs within the S&P 100. Subscription services such as cloud-enabled software, consulting services, long-term contracts, and royalties were all topics of CAMs in the revenue population. In these instances, the revenue collected

often requires management to make estimates about variable consideration, percentage of completion, standalone selling price, allocation of contract price to various performance obligations, and so on, all of which can require significant judgment by management.

The revenue CAMs in our population are as varied as the businesses with which they are associated; however, one theme across the majority of the revenue CAMs relates to timing. Software, consulting projects, and long-term contracts can require companies to recognize revenue over time regardless of when the company is paid. Understanding that timing requires management and, subsequently, their auditors, to use well-reasoned judgment in a complicated and material area.

Industry specific CAMs

The CAQ chose to analyze the S&P 100 in part because it is made up of multiple industry groups. While taxes, goodwill and/or intangibles, contingent liabilities, and revenue were the most common CAMs across the S&P 100, multiple industries exhibited trends within their CAM topics. All auditor's reports for financial institutions with banking operations⁷ had an allowance for loan or lease loss (ALLL) CAM. The only auditor's report with an ALLL CAM that was not a financial institution was an automobile manufacturer.⁸

Other trends observed included multiple insurance contract liabilities CAMs within the insurance industry.⁹ Proven and unproven reserves CAMs and asset retirement and environmental CAMs were prevalent for petroleum refiners.¹⁰ Finally, regulatory assets and liabilities CAMs were common with energy companies serving both residential and commercial energy needs.¹¹

7 National Commerce Banks (SIC code: 6021), Finance Services (SIC code: 6199), and State Commercial Banks (SIC code: 6022)

8 Motor Vehicles and Passenger Car Bodies (SIC code: 3711)

9 Fire, Marine, and Casualty Insurance (SIC code: 6331)

10 Petroleum Refining (SIC code: 2911)

11 Electric Services (SIC code: 4911) and Electric and Other Services Combined (SIC code: 4931)



A closer look at CAMs

In the CAQ's December 2018 publication *Critical Audit Matters: Lessons Learned, Questions to Consider, and an Illustrative Example*, the CAQ provided questions that audit committee members could ask their auditors as the CAM requirements were being implemented. We will revisit some of those topics based on the CAMs we observed in the auditor's reports for S&P 100 companies.

HAS THERE BEEN A CAM FOR EVERY CRITICAL ACCOUNTING POLICY OR ESTIMATE DISCLOSED BY MANAGEMENT?

Within the auditor's reports for the S&P 100, the CAQ observed a single instance of an auditor's report having a CAM for each critical accounting policy or estimate disclosed in the *Management's Discussion and Analysis of Financial Condition and Results of Operations* (MD&A) section of its Form 10-K. Many filings had two to three times the number of critical accounting policies in the MD&A section of their Form 10-K than CAMs communicated in the auditor's report.

In their early analysis of CAMs, the SEC staff observed some connection between CAMs identified by the auditor and critical accounting estimates disclosed in the MD&A, but not a one-to-one relationship. The identified trend is consistent with the SEC staff's expectations, as, despite some similarities between CAMs and critical accounting estimates, their objectives differ.¹² CAMs tend to be a subset of critical accounting estimates, but not every critical accounting estimate necessarily involves especially challenging, subjective, or complex auditor judgment.

The source of CAMs also is broader than just critical accounting estimates; therefore, the auditor may identify CAMs in areas that are not disclosed by management as critical accounting estimates. For example, 12 CAMs in auditor's reports for S&P 100 companies related to a business combination, and only one company also had a critical accounting policy related to business combinations.

¹² Louis J. Collins, Professional Accounting Fellow, Office of the Chief Accountant: *Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments*

WERE THERE ANY CAMS THAT COMMUNICATED A SIGNIFICANT DEFICIENCY IN INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)?

A significant deficiency, in and of itself, cannot be a CAM; such determination, in and of itself, does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. A significant deficiency could, however, be among the principal considerations that led the auditor to determine that a matter is a CAM.¹³ As expected, we did not observe any CAM communications that mentioned a significant deficiency in ICFR.

The description of the principal considerations is meant to provide a clear, concise, and understandable discussion of why the matter is a CAM, including the especially challenging, subjective, or complex auditor judgments made in the context of the particular audit. The “why” is intended to provide information appropriately tailored to the audit and the matter that helps financial statement users understand the aspects of the audit that stood out from the auditor’s perspective.¹⁴

We did observe two auditor’s reports in the population of S&P 100 companies with a CAM that mentioned a material weakness in ICFR as a principal consideration for the CAM. These also were the only two S&P 100 companies that disclosed a material weakness during the 2019 fiscal year. •

¹³ See page 21 of PCAOB Release No. 2017-001.

¹⁴ *Implementation of Critical Audit Matters: A Deeper Dive on the Communication of CAMs*



A closer look at CAMs outside of the S&P 100

The S&P population of filers is made up of many highly capitalized and well-known companies, but it is limited to only 100 of the over 2,000 large accelerated filers for which the CAM requirements were implemented. The entire population provides some additional interesting data points.

WERE THERE ANY AUDITOR'S REPORTS WITHOUT ANY CAMS COMMUNICATED?

There were no companies in the S&P 100 population without CAMs, but we did observe 16 auditor's reports for large accelerated filers without a CAM in the broader population. The determination of CAMs is based on the facts and circumstances of each audit. It is expected that, in most audits to which the CAM requirements apply, the auditor will determine at least one CAM. However, there also may be audits in which the auditor determines there are no CAMs.¹⁵

HOW COMPARABLE ARE CAMS AND KAMS?

Both the PCAOB's and the International Auditing and Assurance Standards Board's (IAASB's) auditor reporting standards were adopted with the overall intent of providing users of auditor's reports with more audit-specific information. The IAASB standard requires auditors to first determine which matters require significant auditor attention, and then determine which of those matters are of most significance to the current period's audit, and therefore constitute key audit matters (KAMs).¹⁶ KAMs, unlike CAMs, may include matters relevant to the audit that are not directly related to accounts and disclosures in the financial statements.

Prior to the implementation of CAMs, KAMs had already been implemented in many jurisdictions. Recognizing the potential similarities, the PCAOB has stated that, although the processes of

¹⁵ *Implementation of Critical Audit Matters: The Basics*

¹⁶ See ISA 701.9-10.

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.¹⁷

While no S&P 100 filings reported both CAMs and KAMs, within the broader population of large accelerated filers there were foreign private issuers that communicated both (CAMs in their PCAOB auditor's report and KAMs in their statutory auditor's report). The CAMs and KAMs included

in several of the reports analyzed by the CAQ were as unique as the companies themselves. In some auditor's reports, there were differences between the number of CAMs and KAMs that were communicated for the same entity. Given the broader definition of KAMs, this is not unexpected. Some KAMs do not directly relate to accounts or disclosures in the financial statements and thus cannot be CAMs under PCAOB standards. There were instances in which the filer's reports included the same quantity and identical topics between CAMs and KAMs, but the description of the CAMs and KAMs varied based on the differing requirements of the standards. •

¹⁷ See page 22 of PCAOB Release No. 2017-001.

Conclusion

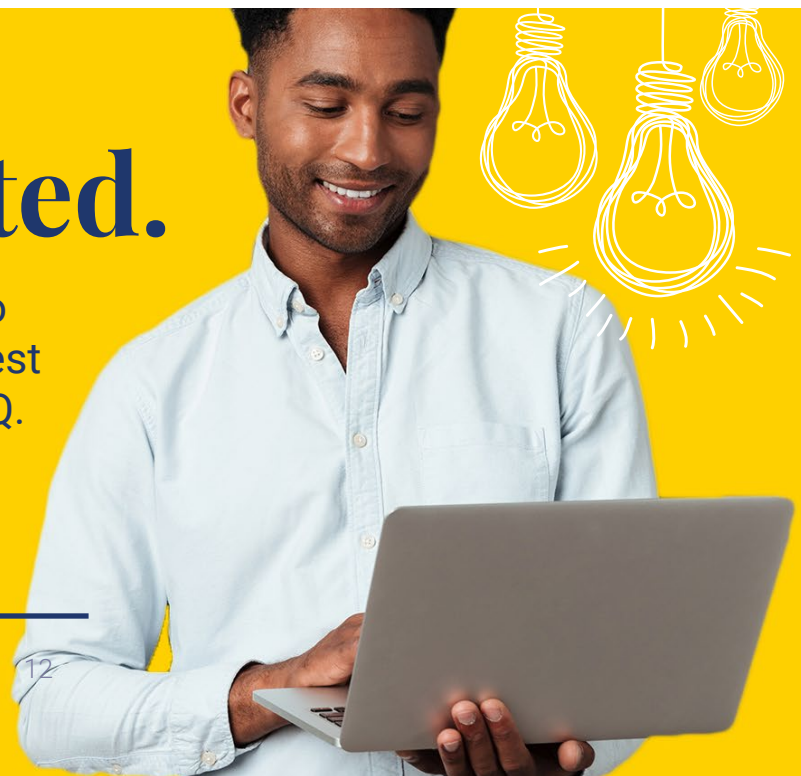
The PCAOB's phased implementation approach of CAMs based on filing status means that, a year from now, thousands more CAMs will be included in auditor's reports. The early trends highlighted within this publication demonstrate the additional transparency provided by auditors within their

reports. The addition of CAMs to the existing mix of publicly disclosed information provides users of auditor's reports with a better understanding of the areas that involve especially challenging, subjective, or complex auditor judgment.

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