AS 3101 PCAOB Critical Audit Matters Disclosure Requirements: New Rules for Public Company Audits

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Today’s speaker:

Catherine M. Clarkin, Partner

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Catherine M. Clarkin, Partner

Cathy Clarkin is a partner in Sullivan & Cromwell’s Capital Markets and Financial Institutions Groups and is the deputy managing partner of the Firm’s Capital Markets Group. She advises clients on a wide variety of capital market transactions across a broad range of industries. Ms. Clarkin has extensive experience in public and private offerings of equity and debt securities by U.S. and non-U.S. issuers, including IPOs, secondary offerings, complex debt issuances, liability management transactions and securities issued in connection with mergers, acquisitions and joint ventures. She regularly advises a broad range of clients on ongoing public company matters, including corporate governance and disclosure matters.

Today’s speaker:

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Jessie X. Wei, Senior Manager

Ms. Wei is a senior manager on EY’s Americas Professional Practice team. She helps develop tools and guidance to enable EY teams to execute high-quality audits. Prior to Ms. Wei's current role, she worked in EY’s assurance practice, serving both public and private companies primarily in the Life Science industry. She has SEC, transactional and multi-national experience assisting clients with initial public offerings, debt offerings, acquisitions, collaborations, divestitures, private equity offerings, as well as implementing Sarbanes-Oxley Section 404 requirements.

Agenda

- Background
- Overview
- Critical Audit Matters (CAMs)
- Global Reporting of Key Audit Matters (KAMs)
  - Comparability of KAMs to CAMs
- Disclosure Considerations and Other Insights
- Resources

Background of Rulemaking Process Leading to PCAOB AS 3101

The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

- In 2008, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession (“ACAP”) issued a report recommending, among other things, that the PCAOB "consider improvements to the auditor's standard reporting model."
- In support of such changes, the ACAP cited the increasing complexity of global business operations, resulting in more complexity in financial reporting and the increased use of complex judgments and estimates such as those relating to fair value.
- Beginning in June 2011, the PCAOB staff conducted outreach to investors, auditors, preparers of financial statements, audit committee members, and other interested parties to seek their views on potential changes to the auditor's report.

Background of Rulemaking Process Leading to PCAOB AS 3101 (cont.)

The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

Investors were generally supportive.	Audit Committees, Management, and Auditors were generally not supportive and were concerned.
• Provide the auditor's views and not those of management. • Allow investors to ask more informed questions about matters relating to the audit of the financial statements. CFA Institute Survey Responses: • More than 70% of survey respondents indicated that the auditor's report is important to their analysis and use of financial reports. • Approximately 60% of survey respondents noted that the auditor's report should include more information about the auditor process itself and matters related to the audited financial statements.	• Sensitivity around disclosing information not disclosed by management. • Disagreements between auditors, management and the audit committee over which matters are CAMs. • Discrepancies between the Company's existing disclosure and the CAMs disclosure. • Investor Misconceptions • "Boilerplate" Concerns • Increased audit costs and time for preparation of the audit report.

[1]CFA Institute Survey, available at: https://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf

Purpose of CAMs

- In response to the feedback received from investors, the CAMs requirement is designed to decrease the information asymmetry between investors and auditors.
- Specifically, CAMs are intended to improve the information available to investors from the auditor’s report by enhancing the following:
  - Communication between auditors and investors, as well as management
  - Transparency, audit quality, and information value
  - Attention by management and financial statement preparers to disclosures referencing the auditor’s report
  - User understanding, consumption, and confidence in audit reports and financial statements
  - Long-term investors’ understanding of the company
  - Support for investor decisions on ratification of the auditor

Overview of PCAOB AS 3101

- PCAOB AS 3101 has two phases and it revises the format of the auditor's report and requires auditor to include:
- **Phase I:**

  - A statement that the auditor is required to be independent
  - Clarification of the auditor's responsibilities related to fraud
  - Information on auditor tenure

  Effective for audits of financial statements for annual reporting periods ending on or after 15 December 2017

Phase II:

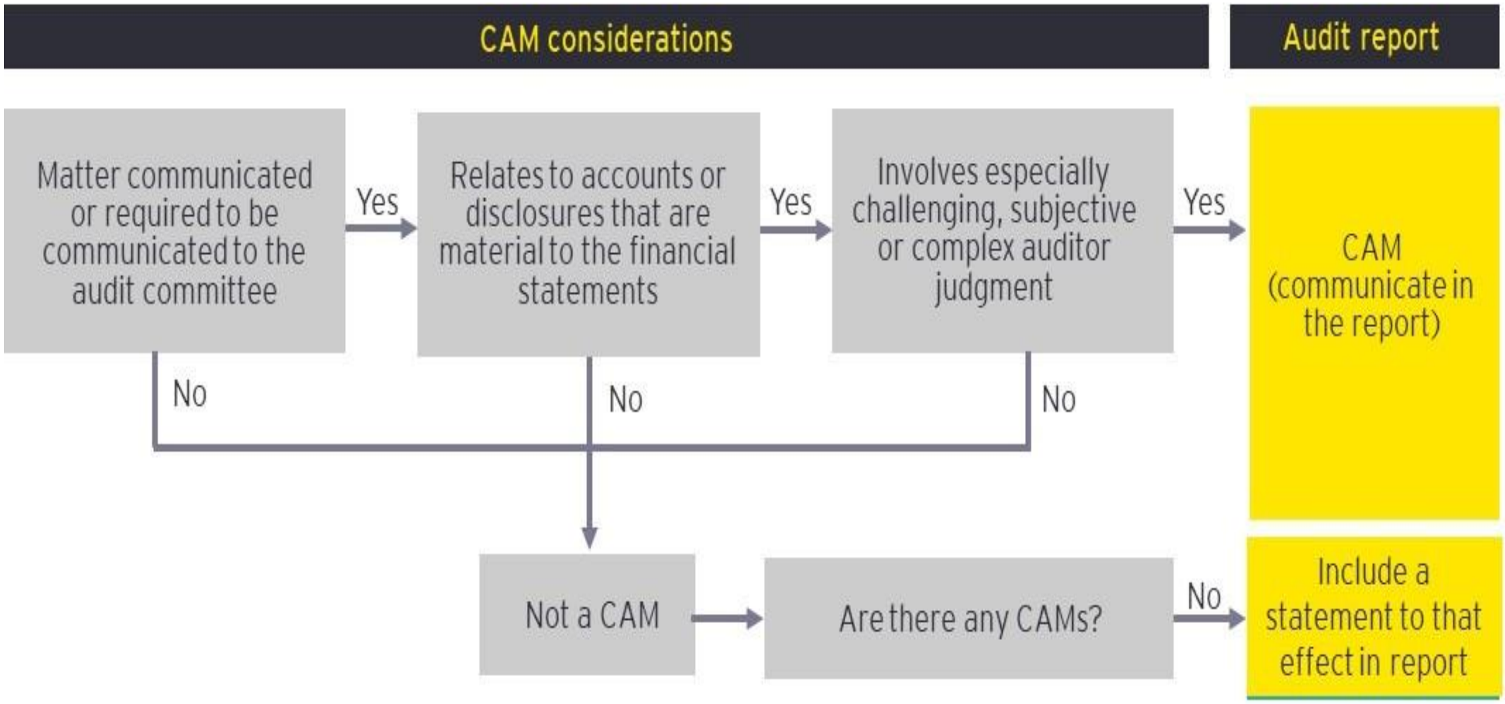
- **A discussion of critical audit matters (CAMs)**

Effective for fiscal years ending on or after 30 June 2019 for audits of large accelerated filers and 15 December 2020 for all other filers

Overview of PCAOB AS 3101

- The Standard applies to all audits conducted under PCAOB standards.
- However, CAMs will not be required for the certain entities:
  - Audits of non-issuer brokers and dealers reporting under Exchange Act Rule 17a-5
  - Investment companies, except those regulated as business development companies (BDCs)
  - Benefit plans (e.g., employee stock purchase, savings and similar plans)
  - Emerging growth companies as defined in Section 3(a)(80) of the Exchange Act

Critical audit matters – determination



Critical audit matters – determination (cont.)

Matters communicated or required to be communicated to the audit committee

- CAMs are selected from the population of matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee

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

- CAMs only include matters that relate to accounts or disclosures that are material to the financial statements
    - A CAM may relate to a component of an account or disclosure that is material to the financial statements
    - A CAM may not necessarily relate to a single account or disclosure, but could have a pervasive effect on the financial statements or relate to many accounts or disclosures
    - A matter that does not relate to a material account or disclosure cannot be a CAM

Critical audit matters – determination (cont.)

Involves especially challenging, subjective or complex auditor judgment

- When determining CAMs, the PCAOB standard provides the auditor a non-exclusive list of factors to consider:
  - Our assessment of the risk of material misstatement, including significant risks
  - 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 our audit team
  - The degree of our judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management
  - The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to those transactions
  - The degree of our subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures
  - The nature of audit evidence obtained regarding the matter
- The PCAOB also requires the auditor to also take into account other factors specific to the audit

Critical audit matters – description

- After the auditors have determined which matters communicated to the audit committee rise to the level of a CAM, the PCAOB standard requires the auditors to include a description of the CAM(s) in the auditor's report. The Standard requires that the description of each CAM include:
  - Identification of the matter – the auditor is required to identify the CAM
  - A reference to the relevant financial statement accounts or disclosures that relate to the CAM – the auditor is required to refer to the relevant financial statement accounts or disclosures
  - An explanation of the principal considerations that led the auditor to determine that the matter is a CAM – the auditor is required to describe the principal considerations that led to the matter being a CAM. The principal considerations should provide a clear, concise and audit specific discussion of why the matter is a CAM
  - An explanation of how the CAM was addressed in the audit
    - Provide a useful summary, not to detail every aspect of how the matter was addressed in the audit
    - Limit the use of highly technical accounting or auditing terms

Global Reporting of Key Audit Matters (KAMs) and Comparability of KAMs to CAMs

- In September 2014, the IAASB adopted changes to the requirements for the auditor's report, including a new requirement for the auditor to communicate "key audit matters" for audits of listed companies.
- These changes were effective for audits of the financial statements for periods ending on or after December 15, 2016.
- Key Audit Matters are those that, "in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period." In determining which matters are KAMs, the IAASB standard notes the following shall be taken into account:
  - Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315.
  - 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.
  - The effect on the audit of significant events or transactions that occurred during the period.

Global Reporting of Key Audit Matters (KAMs) and Comparability of KAMs to CAMs (cont.)

- KAMs versus CAMs
  - Unlike CAMs, KAMs may include matters which are relevant to an audit which are not however directly related to accounts or disclosures in the financial statements.
    - *e.g.* Implementation of a new information technology system.
  - Although the processes of identifying KAMs and CAMs vary under the final standards, 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 both standards.

KAM Trends and Insights

- Insights from KAM implementation[2]:

Average Number:	Varies slightly based on the particular audit firm, but ranges from 2.6 to 3.1 KAMs per audit report.
Most Common Topics:	20% - Asset Impairment and Recoverability 16% - Revenue and Other Income 11% - Valuation of Investments (including Fair Value) 9% - Income Taxes 5% - Business Combinations 5% - Inventory

- These topics are generally consistent with those areas which were most likely to be CAMs in the "dry-runs" of various audit firms.

[2]Source: Audit Analytics – Overview of European Key Audit Matter (KAM) Disclosures, available at: https://blog.auditanalytics.com/overview-of-european-key-audit-matter-kam-disclosures/

Auditors' preparation for CAMs

- Conducting dry runs of the CAM requirements. The purpose of the dry runs is to:
  - Provide an opportunity to apply the standard and prepare for changes to the audit process
  - 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

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 to 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

Disclosure Considerations and Other Insights

- **Investor Perception** – The PCAOB emphasizes that CAMs are not intended to be perceived by investors as problematic or negative. To alleviate this possibility, companies may prepare by taking the following steps:
  - **Timing:** Sufficient time to discuss the CAMs disclosure with the auditor's should be afforded to management and the audit committee to ensure robust dialogue with the auditors.
  - **Company Disclosure:** Management should consider whether revisions are necessary to the company's existing financial disclosures to avoid investor misconceptions that may occur if the CAMs disclosure was read in isolation.
    - Conduct benchmarking of risk-factor disclosure against industry peers
  - **Communication and Responsible Personnel:**
    - To the extent possible, prepare answers for probable investor questions on matters identified as CAMs by the auditors.
    - Ensure company personnel fully understand why the auditors identified the particular matters as CAMs and why they involved "especially challenging, subjective or complex auditor judgment."
    - In advance, delegate responsibility to the appropriate persons within the Company's investor relations to respond to investors.

Disclosure Considerations and Other Insights (cont.)

- **Non-Public Information (original information)** – Because the CAMs disclosure is drafted by the auditors, Companies have expressed concern that CAMs could result in the disclosure of information that is not otherwise publicly disclosed.
  - **Ongoing Dialogue:** Auditors are required to share a draft of the CAMs disclosure with the Audit Committee and Company management in advance. Companies should ensure they are engaged in ongoing dialogue with the auditors to address the disclosure of any non-public information.
  - **Control Deficiencies:**
    - The existence of a material weakness or significant deficiency, in and of itself, does not require identification of a CAM.
    - However, the audit response to deficiencies that constitute a material weakness could be extensive, since the auditor has concluded a reasonable possibility of material misstatement exists. While these items could likely constitute a CAM, there is less disclosure sensitivity around these items because material weaknesses are required to be disclosed.
    - There is no legal requirement to disclose a significant deficiency. If the existence of a significant deficiency was a principal consideration in identifying a particular matter as a CAM, the auditor is required to describe the relevant control-related issues without specific reference to the significant deficiency.

Disclosure Considerations and Other Insights (cont.)

- **CAM Recurrence**
  - Dry-Runs suggest that the likelihood of CAMs reoccurring from year-to-year has been highly company- and industry-specific.
- **Significant Events**
  - Significant events (*e.g.* a cybersecurity breach or natural disaster) posing a risk to the company may result in a CAM and should be discussed with the auditors as soon as possible after such event occurs.
- **Comparability of CAMs Amongst Peers**
  - Dry-Runs suggest that there may be CAMs that are similar within particular industries.
  - However, particular facts and circumstances specific to the audit may result in such companies having different CAMs.

PCAOB resources on CAMs

- 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
  - Implementation of Critical Audit Matters: A Deeper Dive on the Communication of CAMs – Provides the staff's observations about the guidance and answers frequently asked questions about how to communicate CAMs
  - The New Auditor's Report and Critical Audit Matters – a webinar that covers CAM determination, communication, and documentation requirements, as well as other considerations relevant to the CAM requirements
- PCAOB posted two new resources on CAMs, one specifically for investors and the other for audit committees

CAQ resources on CAMs

- Video – Profession in Focus: Critical Audit Matters, Investors, And Investor Relations
- Publication – Investor Relations: Get Up to Speed Now on Critical Audit Matters
- Publication – Insights for Audit Committees: Implementation of Critical Audit Matters
- Webcast – Critical Audit Matters
- 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

AICPA standard

- The AICPA has issued a new standard, SAS No. 134 – *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*.
- The standard is effective for audits of financial statements for periods ending on or after December 15, 2020. While public company auditors are required to comply with the critical audit matters standard of the PCAOB, private company auditors will comply with the standard set forth by the AICPA.
  - When an audit is conducted in accordance with the auditing standards of the PCAOB and the AICPA, the auditor would follow the requirements in the PCAOB standards regarding the determination and reporting of critical audit matters.
- The standard does not require communication of key audit matters unless the auditors have been specifically engaged to provide such communications.
  - Key audit matters are defined as matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements and are selected from matters communicated to those charged with governance.

Thank You

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