

AUDITORS' CAM DISCLOSURES, A MANAGEMENT PERSPECTIVE

By Josef Rashty

CURRICULUM: Accounting and Auditing

LEVEL: Basic

DESIGNED FOR: CPAs in public practice and industry

OBJECTIVES: To address the implications of Critical Audit Matters (CAMs) reporting from the management perspective of public business entities (PBEs), and discuss some of the concerns and cautionary views on CAM disclosures from the management perspective of PBEs.

KEY TOPICS: New auditing standard, AS 3101; SEC guidance and effective date of the standard; scope and management perspective on CAMs; and overview of CAMs identified most often

PREREQUISITES: None

ADVANCED PREPARATION: None

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*. This standard requires the auditors of public business entities (PBEs) to identify and disclose their clients' Critical Audit Matters (CAMs). The presumption is that CAMs will improve the relevance of an audit by providing more insight about the most significant matters that auditors have encountered during their audit.

The objective of CAM is to make the auditor's report more informative and relevant to investors and third-party users. PCAOB defines CAMs as matters arising from the current period audit of financial statements that: (1) the auditor communicates or is required to communicate to the audit committee, and (2) relates to accounts or disclosures that are material to the financial statements, and involves especially challenging, subjective or complex auditor judgment.

This article addresses the implications of CAM reporting from the management perspective of PBEs. There is a purported argument that CAM reporting reduces the information asymmetry among investors; however, some have expressed a lukewarm view of CAM disclosures. This article discusses some of the concerns and cautionary views on CAM disclosures from the management perspective of PBEs, but nevertheless its goal remains not to take naysayers' position.

PCAOB Standard

PCAOB, in its principles-based standard, touted CAM as an investor protection tool and argued that, "[t]he communication of critical audit matters would inform investors and other financial statement users of matters arising from the audit that required especially challenging, subjective or complex auditor judgment, and how the auditor addressed these matters" (Release No. 2017-001). Furthermore, it argued that there is a certain level of "information asymmetry" in financial reporting of public PBEs, where some insiders and certain parties have more and better information than others – CAM's credo is to eliminate or at least reduce such information asymmetry.

PCAOB states that the determination of CAMs is based on the facts and circumstances of each audit. AS 3101 is a principles-based

standard and, as such, it does not specify any matters that always constitute CAMs. PCAOB expects that in most CAM-applicable audits, auditors identify at least one CAM; however, it would be plausible to envision that there would be audits in which the auditor determines there are no CAMs.

In July 2018, the Center for Audit Quality in, *Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements*, recommended the following introductory language in an audit report:

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.

In March 2019, PCAOB in its Staff Guidance Bulletin, *Implementation of Critical Audit Matters: The Basics*, recommends that auditors in the CAM section of the audit report disclose the following:

- Identify CAM(s);
- Describe the principal considerations that led to the identification of a CAM;
- Describe how the audit report addresses the CAM; and
- Make references to financial statements and related disclosures that relate to CAM disclosures.

SEC Guidance

In October 2017, the SEC in its Release No. 34-81916 approved the earlier PCAOB CAM release and concluded that the proposed rules are consistent with the Sarbanes-Oxley Act of 2002 and the securities laws, and are necessary or appropriate in the public interest or for the protection of investors.

Effective Date of the Standard

PCAOB in its Release No. 2017-001 requires that provisions related to CAM will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers, and for fiscal years ending on or after

December 15, 2020, for all other companies to which the requirements apply.

Scope of the CAM

PCAOB in its Release No. 2017-001 notes that the final standard generally applies to audits conducted under PCAOB standards for PBEs. However, it does not require communication of CAM for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5, investment companies other than business development companies, employee stock purchase and other benefit plans, and emerging growth companies (EGCs), as defined in Section 3(a)(80) of the 1934 Securities Exchange Act.

Management Perspective on CAMs

The following subsections describe certain areas that management of PBEs needs to focus on, pursuant to CAM implementation and disclosures in their audit reports.

Management Responsibility for Disclosures

There is an argument that the preparation and disclosure of financial information is primarily the responsibility of the registrants and the auditor's role, by contrast, is to audit the issuers' financial statements and to provide a report thereon. This is certainly a valid argument and it appears, at least on the surface, that CAM has exceeded the traditional auditor's role and has thereby encroached the responsibilities of management.

PCAOB and the SEC have responded to this claim by arguing that having an absolute view on the distinct roles and responsibilities for registrants and auditors is not pragmatic and there is nothing that prohibits exceptions to such a perspective if it exists.

Furthermore, they argued that the unique perspective of auditors in their CAM disclosures provides investors and other users of financial statements valuable insight about their audits. In reference to AS 3101, SEC Release No. 34-81916 states that the auditor is not generally expected to provide information about a company that management has not already made available publicly; however, there are instances that some information may be necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the auditor addressed the matter in the audit.

Conflict Between Management and Auditor Disclosures

Registrants in the Management Discussion and Analysis (MD&A) section of their annual filings provide a discussion of critical accounting estimates (CAEs).

PCAOB, in Appendix to Auditing Standard No. 16, defines a CAE as “An accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material.”

CAEs and other management disclosures have some overlap with CAMs, but they are not the same thing. While some CAEs may be subject to CAMs, CAMs generally have a broader scope and are independent of CAEs. In other words, the auditor may identify matters as CAMs that management has not disclosed as CAEs. If CAMs are simply duplication of CAEs, then the usefulness of CAM disclosures becomes questionable. Clearly, from the investors’ perspective, there is a benefit in receiving information about the audit directly from the auditors’ point of view independent of management.

Nevertheless, CAE disclosures or any other disclosures outside the financial statements need to maintain a fine line and complement the CAMs – the two need to be juxtaposed to get an optimum result. There is a general consensus that CAMs should not overlap management disclosures, but at the same time CAEs and other management disclosures should provide context for CAM disclosures and should not exhibit any confusing and contradictory views. All of this requires a delicate balance, and management and legal counsel should advise the audit committee and opine on the context of CAM disclosures even though such disclosures ultimately remain the responsibility of auditors. The users ultimately benefit from hearing both management and auditors’ perspectives on particular matters in the context of their respective roles.

Management’s SOX 404 Disclosures and CAM

A significant deficiency or material weakness in the internal control over financial reporting of a company does not necessarily initiate a CAM disclosure. The standard for measuring whether an internal control deficiency is a material weakness for financial reporting purposes is that a deficiency or combination of deficiencies could result in a material misstatement of a company’s financial statements. Audit response for significant deficiencies and other less severe deficiencies is usually less extensive than material weaknesses.

There are innumerable ways that internal control deficiencies may occur. When there is a deficiency, the auditor adjusts the audit plan to determine the impact of such deficiency on the financial statements of the company. The severity and frequency of a deficiency determines if a significant deficiency or a material

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weakness exists, but they are not, in and of themselves, considered CAMs. However, a significant deficiency or material weakness could be among the principal considerations that potentially impel the auditor to determine that a matter is a CAM.

Thus, the evaluation and determination process for SOX 404 control deficiencies (AS 2201 and AS 1305) does not necessarily prompt any CAM disclosures, but if the audit response involves especially challenging, subjective or complex judgment, the auditor may decide on CAM disclosures. Nevertheless, for the purposes of evaluating whether a matter falls within the scope of CAM disclosures, the auditors assess the risks of material misstatement, including significant risks, to determine whether a matter requires especially challenging, subjective or complex auditor judgment for a CAM disclosure.

If CAM disclosure was due to significant deficiency, the auditor may disclose the control issue in the broader context of CAM without referencing the “significant deficiency” terminology. However, in case of material weakness, since the company has already reported it in its filings, the auditor can use the term “material weakness” in its CAM disclosures.

For example, if the auditor has detected a significant deficiency in calculation of deferred tax assets, the auditor describes the relevant control-related issues over calculation of deferred tax assets in the broader context of the CAM without using the term significant deficiency. However, if the control deficiency was a material weakness, the auditor can describe the deficiency as a CAM and reference the term material weakness since the company should have already disclosed the material weakness in its filings.

Early Dialogue Between Management and Auditor

As the auditor determines how best to comply with the disclosure requirements of CAM, it must decide on how to discuss and treat sensitive information with the audit committee. CAM disclosures bring increased user attention and can potentially trigger litigations.

Such increased attention may eventually exert an incremental focus on some aspects of management's inadequate or faulty disclosures. This requires an early dialogue between and among management, legal counsel, audit committee and the auditor on how CAMs should be disclosed and presented in an audit report. CAMs' proposed disclosures have an impact on CAEs and significant accounting policies (SAPs) disclosures in Form 10-Ks.

Therefore, the legal counsel and management must ensure that CAM disclosures do not conflict with their CAE and SAP disclosures in their Form 10-Ks. On the other hand, if CAMs are simply duplication of CAEs and SAPs, then the usefulness and applicability of CAM disclosures becomes questionable.

Clearly, from the investors' perspective, there is a benefit in receiving information about the audit directly from the auditors' point of view, but at the same time management needs to establish a workable nexus to avoid any conflict between management's and auditor's disclosures. Any conflicts or surprises in CAE and SAP disclosures can potentially initiate concerns and possibly evoke litigations.

A Wrap Up and Summary

The requirement for communication and disclosure of CAMs is a significant shift in audit reports. The objective is to make the auditor's report more informative and relevant to investors and third-party users.

A company's management has the ultimate responsibility for financial disclosures, but that does not necessarily prohibit the auditors from disclosing the CAMs from their own perspectives in their audit reports. This is not to say that CAM disclosures give the audit report an unflinching consideration that safeguards users of financial statements for any possible irregularity, but nevertheless it is a step in the right direction and time will tell how effective they can be.

Management's CAEs and SAPs have some overlap with CAM disclosures, but they are not necessarily the same thing. While some CAEs and SAPs may be subject to CAMs, CAMs generally have a broader scope and are independent of CAEs and SAPs. However, management

Figure 1: Deloitte's Post-Mortem Analyses

Deloitte in its *Heads Up*, Volume 26, Issue 19, August 30, 2019, reports that in filings of the large accelerated filers with fiscal years ending June 30, 2019, the CAMs most often identified were related to goodwill and intangible assets, revenue and income taxes, and on average, 1.8 CAMs were communicated. Overall, it does not appear so far that the guidance has produced any untoward consequences as some had expected.

Deloitte makes the following observations on its post-mortem analyses and makes an argument that CAMs have become the enduring substratum of an audit:

- Practicing the identification and communication of CAMs allows auditors to gain valuable experience to manage their audit process.
- Deciding whether an account or disclosure is a CAM requires significant judgment and is specific to the circumstances of each audit.
- Communicating CAMs that are easily understood by the broad of directors and executive management can be challenging.
- Sharing the initial draft of CAMs disclosures with management, audit committees and legal counsel is important and sets expectations about CAMs implementation process and disclosures.

must ensure that their CAE and SAP disclosures do not conflict with their auditors' CAM disclosures.

Even though an internal control deficiency per se does not trigger CAM disclosures, it could be among the principal considerations that potentially lead the auditor to determine that a matter should be considered a CAM. Auditors assess the risks of material misstatement, including significant risks, to determine whether a matter requires especially challenging, subjective or complex auditor judgment for CAM disclosures.

Finally, the sensitivity of CAM disclosures requires an early dialogue and interaction among management, legal counsel, audit committee and the auditor on how CAMs should be described and presented in the audit report. Thus, management must ensure that CAE and SAP disclosures in their Form 10-Ks underpin CAM disclosures and do not conflict with them.

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CPE ARTICLE: AUDITORS' CAM DISCLOSURES, A MANAGEMENT PERSPECTIVE

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1. The SEC and PCAOB approved AS 3101 in:

- A. 2017
- B. 2017 and 2018, respectively
- C. 2019
- D. 2020

2. PCAOB believes that the CAM standard:

- A. is a good addition to the U.S. GAAP
- B. is similar to IFRS standards
- C. is a principles-based standard
- D. will eventually replace the U.S. GAAP

3. _____ concluded that the CAM standard is consistent with the Sarbanes-Oxley Act of 2002.

- A. PCAOB
- B. FASB
- C. PBEs
- D. SEC

4. CAM is effective for audits of all PBEs for:

- A. fiscal years after December 15, 2019
- B. fiscal years after June 30, 2019
- C. fiscal years after December 15, 2020
- D. none of the above

5. CAM is applicable:

- A. to all private companies
- B. to all EGCs
- C. to most PBEs
- D. none of the above

6. The article states that CAEs are reflected in:

- A. press releases
- B. MD&As
- C. audit reports
- D. all of the above

7. CAEs are:

- A. management disclosures
- B. auditor's disclosures
- C. both (a) and (b)
- D. neither (a) nor (b)

8. A significant deficiency or a material weakness, in and of itself, _____ considered a CAM.

- A. is never
- B. may possibly be
- C. is always
- D. all of the above

9. CAMs _____ trigger litigation.

- A. never
- B. always
- C. are the only source to
- D. can potentially

10. CAM disclosures are a (an) _____ shift in audit reports.

- A. trivial
- B. significant
- C. expensive
- D. troubling



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