SULLIVAN & CROMWELL LLP

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Critical Audit Matters Guidance

The PCAOB Provides Guidance Regarding Implementation of Critical Audit Matter Requirements

SUMMARY

Last week, the Public Company Accounting Oversight Board ("PCAOB") released three sets of staff guidance regarding the implementation of new critical audit matter ("CAM") standards that auditors of large accelerated filers will be required to include in their audit reports for fiscal years ending on or after June 30, 2019. The guidance documents consist of:

- an overview of the basics of the CAM requirements;
- PCAOB staff observations from a review of audit firms' CAM methodologies; and
- a deeper dive on the determination of CAMs, including PCAOB staff FAQs.[1]

BACKGROUND

On October 23, 2017, the U.S. Securities and Exchange Commission ("SEC") approved the PCAOB's Auditing Standard No. 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("CAMs Standard"), which, among other things, requires auditors to include a discussion of CAMs under a new "Critical Audit Matters" heading in their auditor report.[2] Under this heading, auditors are required to:

- identify each 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.

The CAMs Standard defines a CAM as "[a]ny 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." In determining the second prong, the CAMs Standard directs the auditor to consider the following non-exhaustive list of factors:

- 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.

The PCAOB indicated that it expects CAMs will likely be identified in areas that investors have indicated would be of particular interest to them, such as:

- significant management estimates and judgments made in preparing the financial statements;
- areas of high financial statement and audit risk;
- significant unusual transactions; and
- other significant changes in the financial statements.[3]

The CAM requirements will be effective for audits of large accelerated filers subject to the CAMs Standard for fiscal years ending on or after June 30, 2019, and for other public companies subject to the CAMs Standard for fiscal years ending on or after December 15, 2020. Emerging growth companies and investment companies (other than business development companies) are specifically excluded from the CAM requirements.

THE NEW PCAOB GUIDANCE

In advance of the CAM requirements' effective dates, the staff of the PCAOB ("Staff") has released three guidance documents, which were informed by the PCAOB's discussions with auditors regarding dry runs of the CAMs and its review of methodologies submitted by U.S. audit firms.

A. BASICS GUIDANCE

The first guidance document provides an overview of the basics of the CAM requirements based on the previously released CAMs Standard and is aimed at a broad audience, including financial statement preparers, audit committees and investors. The Basics Guidance includes plain English explanations regarding the definition of a CAM and communication of CAMs, such as that the auditor is not expected to provide information 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. The Basics Guidance also reiterates that while it is expected in most audits to be at least one CAM, there may be audits where the auditor determines there are no CAMs.

B. METHODOLOGY GUIDANCE

The second guidance document presents Staff observations based on a review of methodologies submitted to the PCAOB from ten U.S. audit firms that collectively audit approximately 85% of large accelerated filers. The Methodology Guidance includes observations from the Staff that are intended to inform auditors of the processes they are expected to follow. Although the stated audience of the Methodology Guidance is auditors, other participants in the audit process—most notably audit committees—should take note of the level of detail that they might expect to see in CAM disclosures. The Staff observed the following:

- some methodologies excluded certain audit committee communications in determining CAMs; the Staff noted that methodologies should not exclude any audit committee communication from the population of potential CAMs;
- some methodologies referred only to the six factors listed in the CAMs Standard in determining which matters involved "especially challenging, subjective or complex auditor judgment"; the Staff stressed that in addition to these six factors, auditors' methodologies must also take into account audit-specific factors relevant to the specific audit;
- CAM communications should not simply state that a matter involved especially challenging, subjective or complex auditor judgment, but must also include a clear, concise and understandable discussion of why the matter was especially challenging, subjective or complex, as part of the description of the principal considerations that led to the determination that the matter is a CAM;
- some methodologies directed auditors, in describing how a matter was addressed in the audit, to describe general internal control testing in every CAM communication; the Staff noted that auditors are expected to tailor CAM communications to the audit and the specific circumstances of the matter, which may or may not include describing the testing of relevant controls, depending on the circumstances;
- some methodologies limited auditors to communicating either the relevant account or the relevant disclosure to which a CAM related, but not both; the Staff clarified that methodologies should not limit the ability of the auditor to refer to both accounts *and* disclosures when communicating CAMs;
- methodologies should consider information to be "publicly available" not just if it is disclosed in a financial statement or a document containing financial statements, but also if it is made publicly available in other ways, including through annual reports, press releases or other public statements; and
- while the auditor is required to provide a draft of the auditor's report to the audit committee for discussion, and the PCAOB expects auditors to have a dialogue regarding CAMs with audit committees; CAMs are the responsibility of the auditor, not the audit committee.

C. FAQs GUIDANCE

1. Deeper Dive Observations

The third guidance document provides a "deeper dive" on the determination of CAMs, including Staff observations on two of the elements of the CAM definition—that a CAM (1) relates to accounts or disclosures that are material to the financial statements; and (2) involves especially challenging, subjective or complex auditor judgment—followed by a set of frequently asked questions ("FAQs") answered by the Staff.

In determining whether an account or disclosure is material, materiality is based on both quantitative and qualitative factors. For instance, the Staff provides the following examples:

> A potential loss contingency for which management recorded an accrual and/or made a disclosure could potentially be a CAM. However, a potential loss contingency for which the likelihood was appropriately determined to be remote, and which was not recorded in the financial statements or otherwise disclosed, would not be a CAM because it would not relate to an account or disclosure that is material to the financial statements.
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> A potential illegal act about which management provided disclosure could be determined to be a CAM. Even if the amounts involved were not quantitatively material, such a disclosure on its own may be qualitatively material. On the other hand, if management appropriately determined that no disclosure or accrual was required in the financial statements, the matter could not be a CAM.

Further, a CAM may relate to a component of an account or disclosure that is material to the financial statements. For instance, the Staff notes:

> If goodwill is material to the financial statements, a component of goodwill could potentially be the subject of a CAM. For example, if the auditor's evaluation of the company's goodwill impairment assessment for one of several reporting units involved especially challenging, subjective, or complex judgment, the auditor may determine that a CAM exists even if there is 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.

A CAM may also relate to many accounts or disclosures having a pervasive effect on the financial statements. For instance, the Staff notes:

> The auditor's evaluation of a company's ability to continue as a going concern could represent a CAM, depending on the circumstances of the individual audit.

2. FAQ Guidance

Among the more notable FAQs are the following:

a. How should the auditor apply the requirement to determine matters that involve "especially challenging, subjective or complex auditor judgment"?

This standard is assessed in the context of the many judgments the auditor makes in the audit, and the auditor would consider each of the criteria (that is, is the matter "challenging," "subjective" or "complex" or some combination thereof). The use of the term "especially" conveys that there could be multiple CAMs and that matters are assessed on a relative basis within the specific audit. The auditor's description of the CAM should include a description of which of these criteria were involved in determining the matter was a CAM.

b. How should significant events or matters pertaining to the company's overall business operations or economic or regulatory environment be evaluated for purposes of determining CAMs?

Significant events (for example, natural disasters or cybersecurity breaches) or matters relating to the business or regulatory environment (for example, significant regulatory changes, new accounting standards or significant changes in the economic or business environment or in government operations or policy) could affect the financial statements and become the subject of communications between the auditor and the audit committee. When evaluating such events or matters for purposes of determining CAMs, auditors would consider the impact on the audit, which will largely depend on the nature, timing and extent of the audit response to address any affected accounts and/or disclosures.

For instance, the Staff notes:

> A cybersecurity breach that targeted an issuer's general ledger system may involve especially challenging, subjective, or complex auditor judgment to address, either in auditing specific affected accounts and/or disclosures (for example, a loss contingency recorded in relation to the breach) or more pervasively (if the breach affected multiple accounts or pervasively affected the financial statements). The impact of the breach on the financial statements and therefore on the audit would dictate the nature of any associated CAM(s).

c. How should a material weakness or significant deficiency in internal control over financial reporting be considered when determining CAMs?

The evaluation of the severity of a control deficiency, which includes determining whether a material weakness or significant deficiency exists, would not, in and of itself, be a CAM. However, when a control deficiency exists, the auditor would need to consider the audit response to such deficiency, which may be more or less extensive depending on the deficiency. If auditing the affected account balances and disclosures involved especially challenging, subjective or complex audit judgment, then the auditor would determine one or more CAMs.

If a significant deficiency were among the principle considerations in determining that a matter was a CAM, the auditor is expected to describe the relevant control-related issues over the matter in the broader context of the CAM without using the term "significant deficiency." For material weaknesses, unlike significant deficiencies, there is reporting by the company, so there would be no sensitivity around using that term in a CAM description.

d. What is the relationship between CAMs and a company's disclosures regarding critical accounting estimates?

The critical accounting estimates for which management is required to provide disclosure in MD&A pursuant to SEC interpretive guidance[4] may overlap with CAMs and may be the subject of CAMs, but not all critical accounting estimates necessarily would be. The source of CAMs (all matters communicated or required to be communicated to the audit committee) is broader than just critical accounting estimates and the auditor may identify matters as CAMs that have not been identified as critical accounting estimates.

e. How should "significant risks" be considered in determining whether a matter involved especially challenging, subjective or complex auditor judgment?

It is not expected that all significant risks will give rise to CAMs, or that all CAMs will necessarily be related to identified significant risks.

IMPLICATIONS

The new PCAOB guidance highlights the comprehensive and fact-specific approach that the PCAOB expects auditors to use when determining CAMs and communicating CAMs in their audit reports. Additionally, CAM communications in the auditor's report are expected to be tailored to the specific audit and circumstances regarding the matter. The guidance also reflects ongoing sensitivity on the Staff's part to concerns raised about disclosure in CAMs of previously undisclosed company information; in particular, auditors are specifically expected to avoid referring to previously undisclosed "significant deficiencies" in internal control over financial reporting. At the same time, they may consider anything that an issuer has publicly released, in any format, as having been previously disclosed, for this purpose.

To the extent that issuers have not already done so, it may be beneficial for management and audit committees to review potential CAMs for the most recently completed audit with their auditors on a dry-run basis, discussing how the auditor would have identified and addressed them under the CAMs Standard. Management and the audit committee should also consider the interaction between CAMs and the company's existing disclosures, both in SEC filings and in other public communications, with a view to making sure that those existing disclosures cover matters likely to be addressed in CAMs.

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ENDNOTES

1 PCAOB, Implementation of Critical Audit Matters: The Basics (Mar. 18, 2019), *available at* https://pcaobus.org/Standards/Documents/Implementation-of-Critical-Audit-Matters-The-Basics.pdf; PCAOB, Implementation of Critical Audit Matters: Staff Observations from Review of Audit Methodologies (Mar. 18, 2019), *available at* https://pcaobus.org/Standards/Documents/Implementation-of-Critical-Audit-Matters-Review-Audit-Methodologies.pdf; PCAOB, Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs (Mar. 18, 2019), *available at* https://pcaobus.org/Standards/Documents/Implementation-of-Critical-Audit-Matters-Deeper-Dive.pdf.

2 For further information about the CAMs Standard, see our client memorandum SEC Approves New PCAOB Auditor Reporting Standard, dated October 30, 2017, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Approves_New_PCAOB_Auditor_Reporting_Standard.pdf. See also PCAOB Release No. 2017-001, Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (June 1, 2017), *available at* https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf.

3 See PCAOB Release No. 2017-001, at IV.A.1.a.i, p. 17.

4 Under the SEC interpretation, companies should include disclosure in their Management's Discussion and Analysis about accounting estimates or assumptions where: (1) the nature of the estimates or assumptions 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 (2) the impact of the estimates and assumptions on financial condition or operating performance is material. SEC Release No. 33-8350, 34-48960, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (Dec. 29, 2003), *available at* https://www.sec.gov/rules/interp/33-8350.htm.

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