

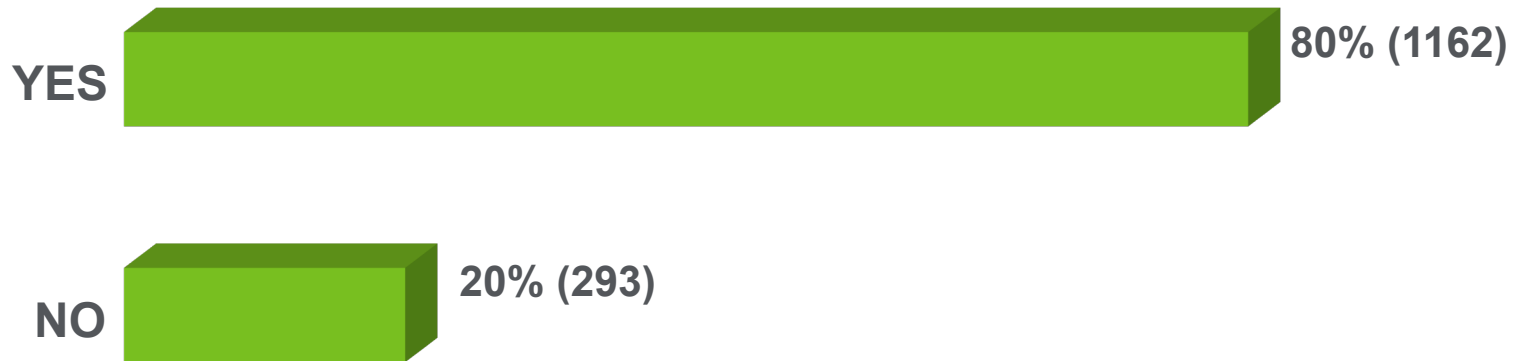
Briefing to the PCAOB – Critical Audit Matters

Subcommittee on Standards
PCAOB Investor Advisory Group Meeting
June 7, 2023

The views expressed in these slides are solely the views of the Investor Advisory Group members who prepared them and do not necessarily reflect the views of the PCAOB, the members of the Board, the PCAOB staff, the IAG's individual members, or the organizations by which they are employed. The PCAOB makes no representation as to the accuracy or completeness of this information.

June 7, 2023

Should the independent external auditors report provide specific information about how the auditors reach their unqualified opinion indicating that a company has fairly presented its financial statements in accordance with the required financial reporting standards?



If you answered yes, please rate on a scale of 1 (not important) to 5 (very important) the importance of having auditors discuss and/or describe the audit findings or procedures performed and/or areas of special interest to auditors.

KEY RISKS - Key risk areas identified as part of the risk evaluation of a company's business model.



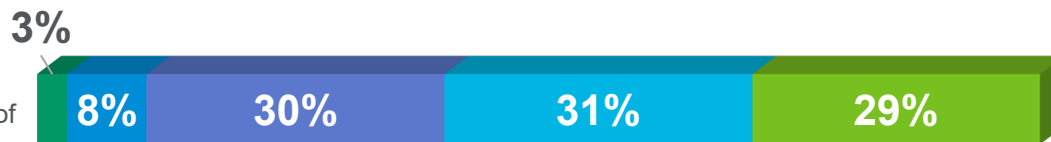
IMPACT OF CHANGES IN KEY RISKS ON AUDIT PROCEDURES - Significant changes in risk exposures affecting the audit procedures and/or ability to exercise professional judgement.



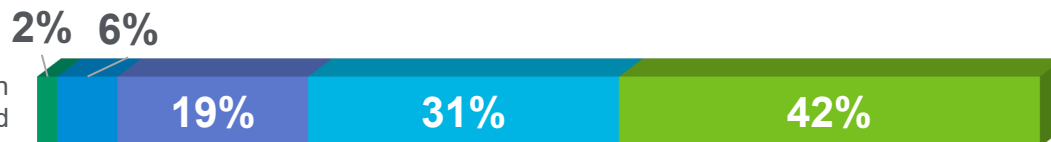
ITEMS WITH HIGH DEGREE OOF MEASUREMENT UNCERTAINTY - Reported amounts, or changes in amounts, that have a high degree of uncertainty in measurement, that involve significant assumptions subject to change, or otherwise require a higher level of professional judgment.



MATERIALITY - Assessment of materiality, i.e., the threshold for determining the recognition and disclosure of information in the financial statements.



CHANGES IN ACCOUNTING PRINCIPLES - Changes in accounting principles affecting the consistency of reported amounts.



AUDITOR TENURE - Disclosure about the auditors tenure (e.g., years auditing the company) and other non-audit services provided during the period covered by the auditors report.



N≈1183

PANELISTS



Martin Baumann
Professor, The Washington Campus



Colleen Honigsberg
Professor of Law, Stanford University



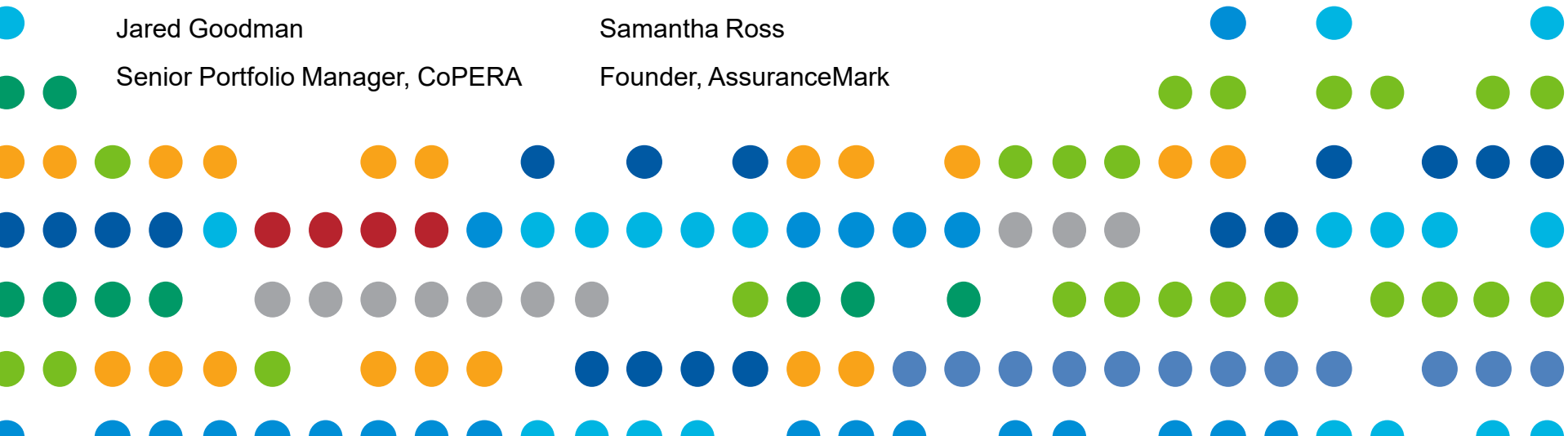
Sandra Peters – Moderator
Senior Head, Global Advocacy & Government Affairs, CFA Institute



Jared Goodman
Senior Portfolio Manager, CoPERA

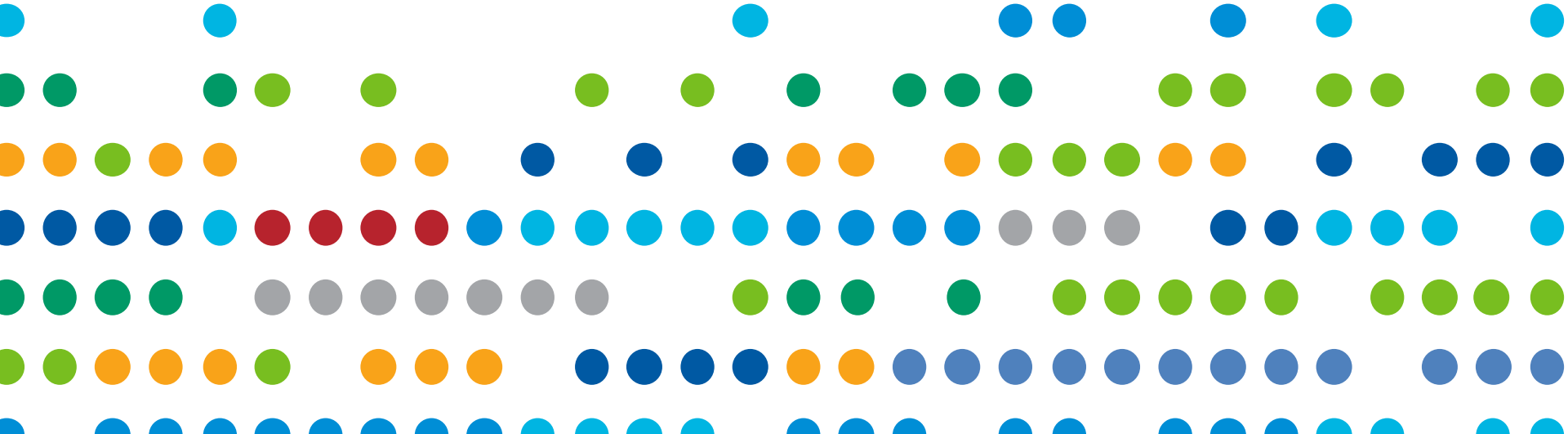


Samantha Ross
Founder, AssuranceMark

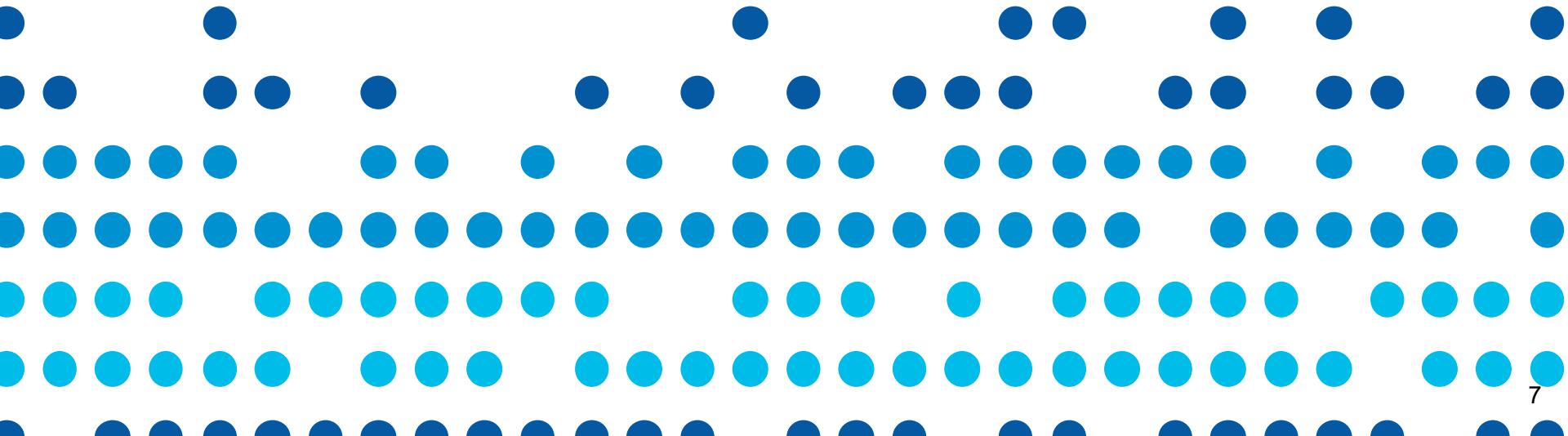


AGENDA

- OBJECTIVE
- BACKGROUND AND HISTORY OF CAMS
- ANECDOTAL OBSERVATIONS
- INVESTOR PERSPECTIVES
- ACADEMIC RESEARCH
- QUESTIONS FROM INVESTOR ADVISORY GROUP MEMBERS
- SUGGESTED IMPROVEMENTS & WAY FORWARD



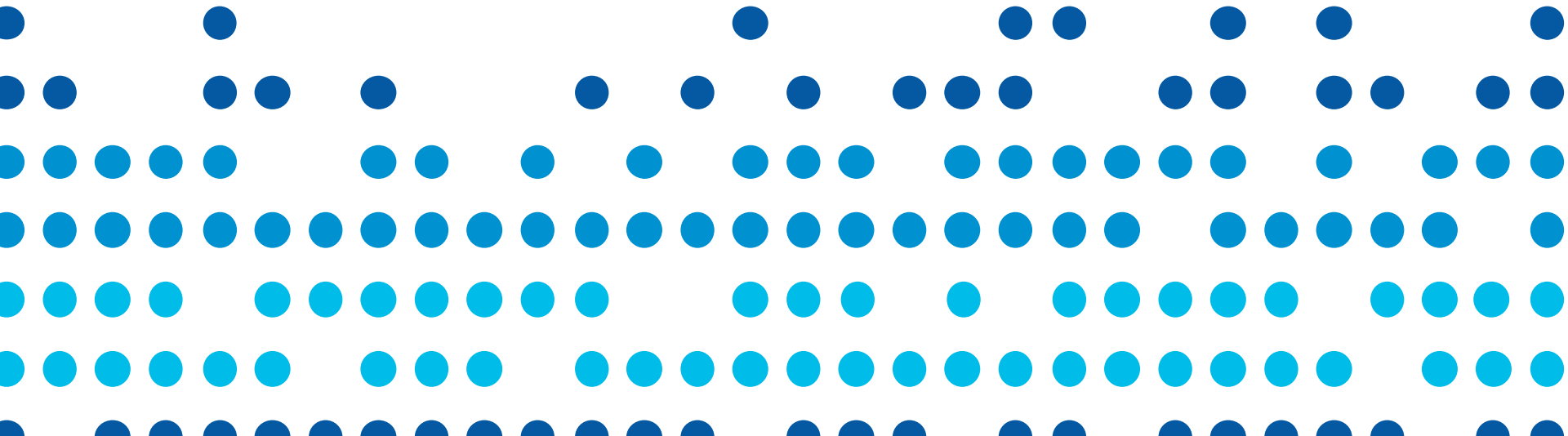
BACKGROUND AND HISTORY OF CAMS



CRITICAL AUDIT MATTERS

A CAM IS ANY MATTER ARISING FROM THE AUDIT OF THE FINANCIAL STATEMENTS THAT WAS COMMUNICATED OR REQUIRED TO BE COMMUNICATED TO THE AUDIT COMMITTEE AND THAT:

- **RELATES TO ACCOUNTS OR DISCLOSURES THAT ARE MATERIAL TO THE FINANCIAL STATEMENTS; AND**
- **INVOLVED ESPECIALLY CHALLENGING, SUBJECTIVE, OR COMPLEX AUDITOR JUDGMENT**



REQUIRED COMMUNICATIONS TO THE AUDIT COMMITTEE UNDER PCAOB STANDARDS INCLUDE, AMONG MANY OTHER THINGS:

1. SIGNIFICANT RISKS IDENTIFIED BY THE AUDITOR
2. CRITICAL ACCOUNTING POLICIES AND PRACTICES
3. SIGNIFICANT UNUSUAL TRANSACTIONS
4. QUALITATIVE ASPECTS OF THE COMPANY'S ACCOUNTING
5. ASSESSMENT OF AND CONCLUSIONS REGARDING CRITICAL ACCOUNTING ESTIMATES
6. FINANCIAL STATEMENT PRESENTATION
7. MATTERS CONSULTED OUTSIDE THE ENGAGEMENT TEAM (E.G., NATIONAL OFFICE, INDUSTRY OR OTHER SPECIALISTS, ETC.)
8. CORRECTED AND UNCORRECTED MISSTATEMENTS
9. DIFFICULTIES ENCOUNTERED, INCLUDING UNEXPECTED EXTENSIVE EFFORT REQUIRED
10. ANY MATTER SIGNIFICANT TO THE AUDIT COMMITTEE'S OVERSIGHT

THE AUDITOR SHOULD TAKE INTO ACCOUNT THE FOLLOWING NON-EXCLUSIVE FACTORS IN ASSESSING WHETHER ANY PARTICULAR MATTER COMMUNICATED TO THE AUDIT COMMITTEE IS A CAM:

1. AUDITOR'S ASSESSMENT OF THE RISKS OF MATERIAL MISSTATEMENT, INCLUDING SIGNIFICANT RISKS
2. DEGREE OF AUDITOR JUDGMENT RELATED TO FINANCIAL STATEMENT AREAS INVOLVING SIGNIFICANT JUDGMENT OR ESTIMATION BY MANAGEMENT
3. ESTIMATES WITH SIGNIFICANT MEASUREMENT UNCERTAINTY
4. AUDIT EFFORT WITH RESPECT TO SIGNIFICANT UNUSUAL TRANSACTIONS
5. DEGREE OF AUDITOR SUBJECTIVITY IN APPLYING AUDIT PROCEDURES
6. NATURE AND EXTENT OF AUDIT EFFORT REQUIRED TO ADDRESS THE MATTER
7. EXTENT OF SPECIALIZED SKILL OR KNOWLEDGE NEEDED OR CONSULTATIONS OUTSIDE THE ENGAGEMENT TEAM TO ADDRESS THE MATTER
8. NATURE OF AUDIT EVIDENCE OBTAINED REGARDING THE MATTER (E.G., LEVEL 3 FAIR VALUES, ETC.)

DOCUMENTATION OF CAMS

FOR EACH MATTER ARISING FROM THE AUDIT THAT:

1. WAS COMMUNICATED TO THE AUDIT COMMITTEE; AND
2. RELATES TO ACCOUNTS OR DISCLOSURES THAT ARE MATERIAL;

THE AUDITOR MUST DOCUMENT WHETHER OR NOT THE MATTER WAS DETERMINED TO BE A CRITICAL AUDIT MATTER AND THE BASIS FOR THAT DETERMINATION.

PCAOB STAFF GUIDANCE ON CAM IMPLEMENTATION

PCAOB staff has issued several pieces of Staff Guidance, including

1. Staff Observations from Review of Audit Methodologies
2. Implementation: The Basics
3. A Deeper Dive on the Determination of CAMs
4. A Deeper Dive on Communication of CAMs

Among other things, the Guidance makes clear that “especially” was chosen instead of “most”, as originally proposed to convey clearly that there could be multiple CAMs.

THE OUTCOME TO DATE

- ACADEMIC RESEARCH IS SOMEWHAT LIMITED
- RESEARCH HAS SHOWN ABOUT 1.5 CAMS (I.E., ONE OR TWO) DISCLOSED IN LARGE FIRM AUDITS
- AUDITORS DERIVE “COMFORT” FROM DISCLOSING WHAT OTHERS ARE
- MEETING INVESTOR EXPECTATIONS?

HOW TO IMPROVE CAM REPORTING

- THE AUDIT PROFESSION
- PCAOB INSPECTIONS
- MODIFYING CAM LANGUAGE IN THE STANDARD (AMEND THE RULE)

IAASB KEY AUDIT MATTERS (K-KAMS)

- K-KAMS HAVE A DIFFERENT DEFINITION BUT EXPECTATIONS WERE THAT THE TWO STANDARDS WOULD RESULT IN LARGELY SIMILAR RESULTS
- KEY AUDIT MATTERS (KAMS) ARE DEFINED AS:
“THOSE MATTERS THAT, IN THE AUDITOR’S PROFESSIONAL JUDGMENT, WERE OF MOST SIGNIFICANCE IN THE AUDIT OF THE FINANCIAL STATEMENTS OF THE CURRENT PERIOD. KEY AUDIT MATTERS ARE SELECTED FROM MATTERS COMMUNICATED WITH THOSE CHARGED WITH GOVERNANCE.”

POSSIBLE OTHER ALTERNATIVE LANGUAGE TO BE CONSIDERED BY THE PCAOB

CRITICAL AUDIT MATTERS ARE DEFINED AS THOSE MATTERS ARISING FROM THE 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. *WERE THE MORE CHALLENGING, SUBJECTIVE OR COMPLEX MATTERS ADDRESSED IN THE AUDIT*

Stanford Law School

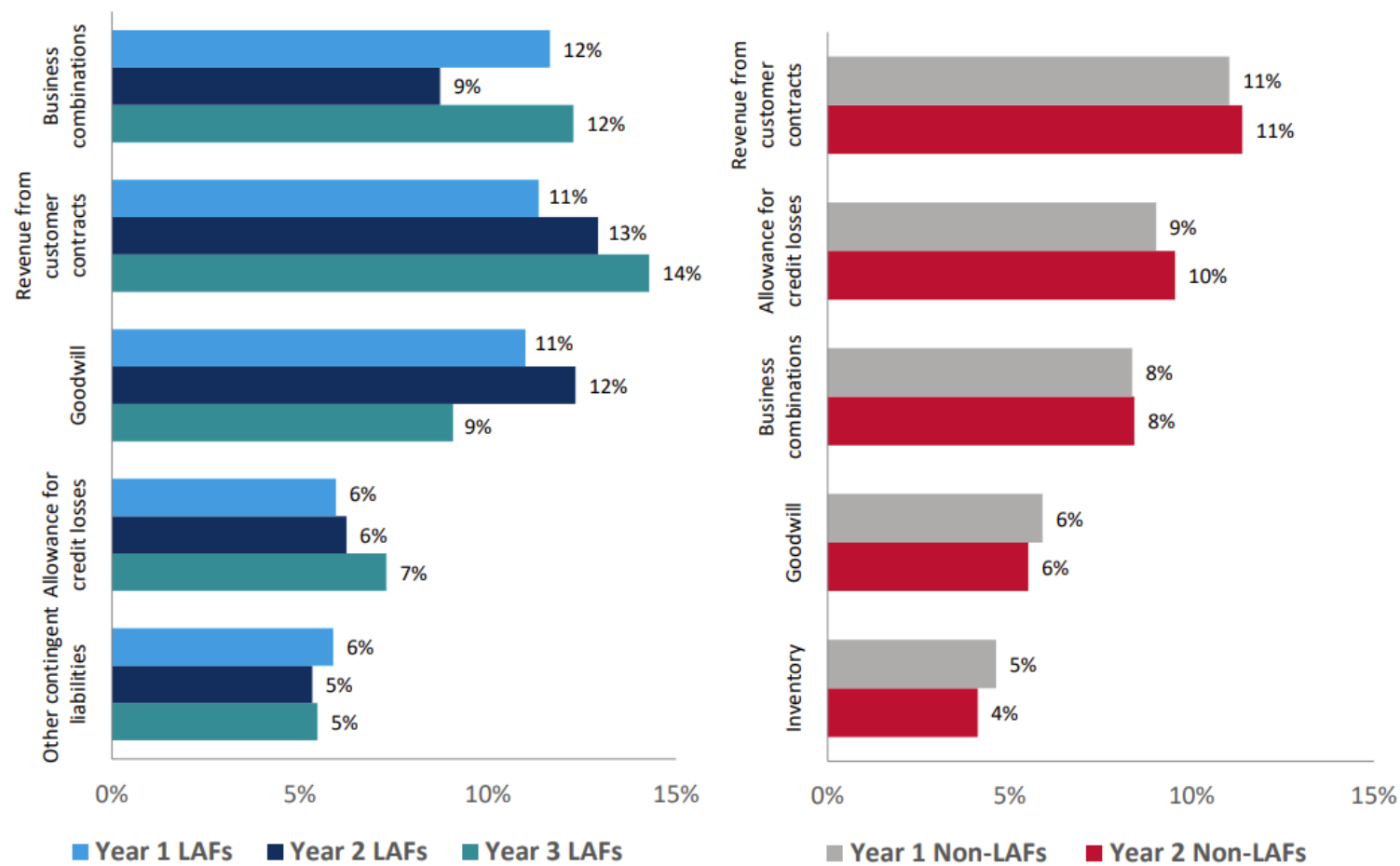
PCAOB Investor Advisory Group
Critical Audit Matters – Academic Findings
June 7th, 2023

Literature on CAMs

The PCAOB's 2022 Interim Analysis Report provides important summary statistics on CAMs.

- The average number of CAMs per audit report has declined over time (from 1.69 in to 1.43 for LAFs)
- The proportion of audit reports that communicate a single CAM has increased.
- Less than half of investor respondents thought that CAMs were easy to understand (44%) or tailored to the audit (40%).

Most Frequently Communicated CAMs



Source: Figure 2 from the PCAOB’s Second Econometric Analysis on the Initial Implementation of CAM Requirements, Dec. 2022

Academic Literature on CAMs

- Most studies do not find that CAMs, on average, provide incremental information to investors, but there's some evidence that CAMs can be informative in marginal situations (e.g., firms with high short interest or those that just met earnings).
 - See *Burke, et al., 2022; Carver & Trinkle 2017.*
- There's evidence that the number of reported CAMs was meaningful when CAMs were initially required, but that finding seems to have disappeared as the number of CAMs reported has standardized.
 - See *Klevak et al., 2022; Sulcaj 2020.*
- There's a disconnect between these empirical studies and experimental work showing that "investors" change their investment decisions based on CAMs.
 - See *Kachelmeier, et al., 2019; Christensen, Glover, Wolfe 2014.*

Other Fun Facts from Academic Work

- Investors raise the issues noted in CAMs in earnings calls.
 - *Klevak et al 2022*
- There are significant changes to financial statement footnotes referenced by CAMs, suggesting that managers supplement disclosure in areas that are expected to be scrutinized following the CAM disclosure.
 - *See Burke, et al., 2022*
- Investors react more negatively to M&A announcements when the audit report contains a business combination CAM.
 - *Abbott & Buslepp 2022*
- For the small sample of cross-listed firms that report both CAMs and KAMs, firms report more KAMs than CAMs, and those KAMs are longer. The authors find no evidence of differences in earnings persistence, but it is difficult to interpret that finding.
 - *Nyler, Wangerin, Zehms, 2023*

Limitations in Academic Work

- Empirical literature on CAMs suffers from several limitations.
 - Cannot determine whether disclosed CAMs represent the full set of what should be disclosed.
 - Limited to proxies such as abnormal stock returns and earnings response coefficients that are difficult to interpret, particularly given concurrent disclosures.
 - An analysis focused on the current state of disclosures is not always helpful in guiding what disclosures should look like.
- Critically, there has been little academic study on whether the CAMs disclosed
 - (1) relate to the issues that investors care about, or
 - (2) represents the full set that should be disclosed.

Short-Seller Reports & CAMs

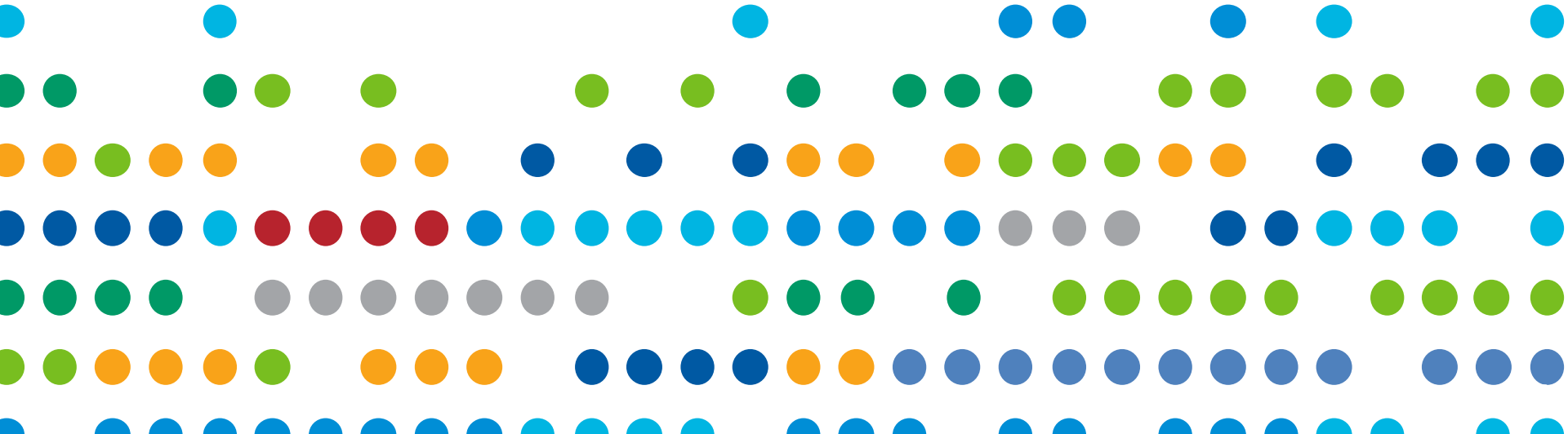
- To better understand whether the CAMs disclosed address the accounting and auditing issues important to investors, I pulled all short-seller reports produced by Muddy Waters and Hindenburg over the past year.
- I identified all accounting and auditing related issues listed in the reports, and I compared them to CAMs for the same companies.
- There was zero overlap.
- Of course, the short-seller reports are an imperfect proxy for investor interest. And the issues the short-sellers identify are not necessarily CAMs.
- Nonetheless, the lack of any overlap begs questions about the utility of CAMs and whether they address the most important issues.

CAMs & Bankruptcy

- CAMs may be particularly important for distressed firms, so I pulled the CAMs for all public companies that filed for bankruptcy in Q1, 2023.
- Two key points:
 - Of the 65 companies, only 20 had CAMs. Most of the others were EGCs.
 - There appeared to be confusion over the overlap and interaction between the CAM and Going Concern language.

Critical Audit Matter	Num.
Impairment of goodwill/intangibles	5
Going Concern	4
Impairment of physical assets	3
Clinical Study Accrual	2
Inventory reserves	2
Revenue recognition	2
Accounts receivable	1
Allowance for loan losses	1
Contingent liabilities	1
Fair value of securities	1
Liquidity	1
PPE	1
Reserves	1
Restructuring & impairment	1
Taxes	1
Warranty liability	1

APPENDIX: BIOS



BIOS

Martin Baumann serves as an adjunct professor with The Washington Campus, helping lead its programs in accounting and public policy and financial regulation.

Mr. Martin Baumann is the former Chief Auditor and Director of Professional Standards at the Public Company Accounting Oversight Board (PCAOB). He oversaw landmark standard-setting projects in recent years to benefit investors by increasing the transparency of the audit and the usefulness of the audit report. He also oversaw the drafting and adoption of a suite of eight new auditing standards that created a new framework to enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in financial statements.

Mr. Baumann joined the PCAOB in 2006, and served as Director of the Office of Research and Analysis from 2007 to 2009, before becoming Chief Auditor. In this role, he led a team that evaluated emerging accounting and auditing risks to inform all the key functions of the PCAOB.

Prior to joining the PCAOB, Mr. Baumann served as an Executive Vice President of Finance and Chief Financial Officer of Freddie Mac with responsibility for accounting, corporate planning, taxation, shareholder relations, and market and operating risk oversight. Mr. Baumann joined Freddie Mac having served as Partner, and Deputy Chairman of the World Financial Services Practice, and as Global Banking Leader for PricewaterhouseCoopers.

Mr. Baumann earned a Bachelor of Arts in accounting from Queens College and a Master in Business Administration in finance from Baruch College. He also completed Columbia Business School's Executive Program in Business Administration. He is a certified public accountant.

Jared Goodman is a Senior Portfolio Manager at Colorado Public Employees Retirement Association (CoPERA), managing a \$2.5b U.S. SMID cap portfolio and covering Industrials and Healthcare as a global sector analyst. Before working at CoPERA, Mr. Goodman was an equity research analyst for UBS Investment Bank and a KPMG consultant, advising on internal controls and operational strategies. He graduated from the University of Southern California and obtained an MBA from Cornell University. Mr. Goodman is a CFA Charterholder and a Certified Fraud Examiner.

Colleen Honigsberg is a Professor of Law at Stanford Law School, where her research is focused on the empirical study of corporate and securities law. Her recent papers have examined gaps in the regulatory environment for financial advisors, carbon accounting, human capital accounting, and the incentive structure for auditors. Her research has been featured in major mainstream publications such as the Economist, the Wall Street Journal, and the New York Times, and her scholarship has been published in leading academic journals such as the Journal of Financial Economics, the Journal of Law & Economics, the Stanford Law Review, and the Journal of Accounting Research. She currently sits on the Securities and Exchange Commission's Investor Advisory Committee.

Prior to joining the faculty in 2016, Professor Honigsberg received her Ph.D. from Columbia Business School and her J.D. from Columbia Law School. She has expertise in accounting and previously worked as a Certified Public Accountant for PricewaterhouseCoopers Advisory Services and for Compass Lexecon. In addition, she previously served as a Senior Economic Research Fellow with the Public Company Accounting Oversight Board.

Education & Professional Certifications

- Columbia Business School, Ph.D., 2016
- New York Bar Admission. 2012.
- Columbia Law School, J.D., 2011
- Certified Public Accountant. California, 2006
- University of California, Los Angeles, B.S., 2005

BIOS

Samantha Ross was the PCAOB's first chief of staff, serving in that role throughout the term of Chairman William J. McDonough. She was special counsel to Chairman James R. Doty since he joined the PCAOB in February 2011. She also served as the top staffer to former Board Member Charles D. Niemeier, including during his time as acting chairman. Over 15 years, as the PCAOB grew to more than 800 employees, she played an integral role in the establishment, growth, management and direction of the PCAOB.

In her capacity advising PCAOB chairmen, she had a significant role in most of the PCAOB's major policy initiatives, including development of the PCAOB's:

- Center for Economic Analysis;
- modernization of the auditor's reporting model;
- rule on audit transparency, providing for disclosure of engagement partners and other firms that participate in audits;
- auditor independence initiatives, such as the PCAOB's rules prohibiting auditor involvement in designing tax shelters and other tax services;
- Audit Committee Dialogue publication and podcast series; and,
- annual budgets and strategic plans.

Before joining the PCAOB, she was special counsel to the chief accountant of the Securities and Exchange Commission's Division of Enforcement. Earlier in her career, she was a law clerk to the Hon. John E. Sprizzo, federal judge for the U.S. District Court for the Southern District of New York, and an associate at the law firm of Sullivan & Cromwell.

Sandra Peters leads the Financial Reporting Policy Group at CFA Institute where she oversees a team responsible for tracking all corporate disclosure issues of interest to investors (e.g., financial reporting, auditing and ESG disclosures). She serves as spokesperson for CFA Institute to policymakers, standard setters, and regulators (e.g., IASB, FASB, SASB, ISSB, U.S. Securities and Exchange Commission, European Commission, etc.) and conducts outreach to other professional organizations and the media to discuss and promote data for investment decision-making.

Sandy has an extensive and well-balanced background as a user advocate, preparer, and auditor. Most recently, Sandy served as Vice President and Corporate Controller at MetLife Inc. Prior to joining MetLife, she was a partner at KPMG LLP providing audit services primarily for insurance and financial services companies.

She is currently a member of the SEC's Investor Advisory Committee and the PCAOB's newly formed Investor Advisory Group as well as the Standards and Emerging Issues Advisory Group. Sandy was previously was a member of the IFRS Interpretation's Committee (IFRS IC), the PCAOB's Standing Advisory Group and the FASB's Financial Accounting Standards Advisory Council (FASAC).

Sandy is a CPA licensed in New York, Texas, and Nebraska. She earned the CFA designation in 1998 and is a member of the CFA Society of New York.

She holds a BSBA in Accounting from the University of Nebraska and an MBA in Finance from Indiana University.