ICAEW
REPRESENTATION 39/20

REQUEST FOR COMMENT INTERIM ANALYSIS OF CRITICAL AUDIT MATTER REQUIREMENTS

Issued 15 June 2020

Auditor reporting is an important issue for investors globally and we welcome this opportunity to respond to the PCAOB's request for comment on its Interim Analysis of Critical Audit Matter Requirements published on April 17, 2020, a copy of which is available here.

This response of 15 June 2020 has been prepared by the ICAEW Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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KEY POINTS

1. The PCAOB's changes to auditor reporting requirements were designed to make the audit report more relevant and informative to investors and other financial statement users by requiring more information about audit matters that required especially challenging, subjective, or complex auditor judgment, and about how auditors responded. It is clear that the new requirements have and will continue to achieve this objective.
2. The FRC in the UK and the IAASB internationally have already enhanced auditor reporting and the PCAOB's initiative adds more again to investor understanding of the audit. The effectiveness of all auditor reporting regimes depends partly on the quality of implementation by auditors, but also on the extent to which auditing standard-setters have the confidence and maturity to learn from experience, including the experience of others. We commend the PCAOB on this request for comment which demonstrates its commitment to that learning. The FRC and the IAASB are also committed to on-going reviews of the effectiveness of the regimes they have adopted.
3. Investors will expect to see improvements in auditor reporting over time, but they will also expect to see changes in auditor reporting requirements where necessary. The PCAOB should avoid excessive focus on failures in execution, particularly if it becomes clear that investors are looking for something different altogether. There are on-going discussions about the cost and value of operating different regimes and all auditing standard-setters need to explore how the private communications between auditors and audit committees can be better and safely communicated to investors and others. Standard-setters should also seek to align their respective requirements to a greater extent than they have to date.
4. The questions posed by the PCAOB imply an expectation of change in the relationships between and activities of preparers, management and auditors as a result of the introduction of CAM - perhaps significant change. A similar overarching objective when KAM were introduced in the UK was to help investors and companies to start a dialogue. However, structural barriers to direct engagement between investors and companies and a desire among some investors to engage directly with auditors, rather than company management, mean that it is important to have realistic expectations. We have concerns about the idea that changes in the behaviour of preparers and management can be achieved by means of changes to auditor reporting requirements. If the behaviour of preparers and management needs to change, changes need to be made to requirements governing their behaviour, not that of auditors.
5. Investors, analysts, users, preparers and auditors of financial statements all have an interest in the differences between CAM as reported in the USA, and CAM or KAM as reported in UK, Europe and elsewhere. This is not a matter of idle curiosity. Understanding these differences is one way for all involved to improve the quality and value of reporting locally. The PCAOB as a mature standard-setter understands this well. As it develops its thinking in this area, it can afford to be clear about those differences, what it can learn from experience in other jurisdictions, and what it believes are the limitations of reporting under different regimes.
6. Organisations such as Audit Analytics and audit regulators such as the FRC in the UK provide information on the differences in reporting: there are clear differences in the number and nature of CAM or their broad equivalents reported by US domestic issuers, Canadian issuers, US FPIs and companies in the UK and Europe, for example.
7. The PCAOB is aware that investors are interested in these matters and that some auditors seek to minimise the differences in reporting where possible. The PCAOB has chosen to adopt a reporting model that diverges from the model adopted by the IAASB. In the coming

months and years, the PCAOB will be called on to defend that position, and to modify it, if investors believe it warranted. We therefore encourage the PCAOB to seek to analyse and understand these differences through its public outreach, as well as privately, to better serve investors.

8. The COVID-19 pandemic heightens the importance of CAM and KAM reporting. We do not yet know how the differences in reporting will play out in the uncharted waters in which we all find ourselves, but the scale of business failures in the coming months is unlikely to create a more benign environment for auditors. Transparency and an honest discussion of the differences sooner rather than later must be in the interest of all stakeholders, including investors. We welcome that debate.

ANSWERS TO SPECIFIC QUESTIONS

In our answers to the PCAOB's questions to preparers, audit committee members and auditors, we make observations based on the experience of UK auditors of FPIs and UK-based Domestic registrants.

In our answers to the PCAOB's questions to investors, analysts and other financial statement users, we make observations based on our experience of UK KAM and US CAM. We believe there are sufficient similarities to make such observations relevant.

Questions for investors, analysts, and other financial statement users

Question 1. Have you as an investor, analyst, or other financial statement user read any auditors' reports that contain CAMs? Approximately how many? Why did you read them? Prior to CAM implementation, did you read auditors' reports?

9. Informal outreach suggests that, as might be expected, when enhanced auditor reporting was first introduced in the UK, investors, analysts and other financial statement users - particularly those with a background in accountancy - did start to read audit reports, for the first time.

   'I looked at a few - more than 10, less than 50 to see whether I thought they would provide useful information'. Investor

10. Unmodified auditors' reports were not read prior to that because they rarely contained company-specific information.

11. It also seems likely that investors, analysts and other financial statement users also read summaries of the number and nature of KAM and CAM reported in the UK and elsewhere, such as those provided by Audit Analytics and audit regulators, such as the FRC in the UK.

Question 2. *What effects, if any, have investors, analysts, or other financial statement users experienced from the communication of CAMs in the auditor's report? For example, have any of the following changed as a result of CAM communications:*

(a) Ability to analyze companies' financial statements or make investment decisions;

(b) Content of analyst reports or internal buy/sell/hold recommendations;

(c) Interactions with management, such as developing new or better-informed questions;

(d) Understanding of disclosures made by company management (e.g., in MD&A);

(e) Understanding of auditors' work

(f) Proxy voting decisions, including ratification of the audit committee's choice of external auditor.

Please describe how CAM communications contributed to the changes and, if applicable, whether you anticipate additional changes in the future.

12. Enhancements to investor understanding and better quality analysis are both hard to measure but the publication of KAM in the UK undoubtedly provides additional value to investors. KAM are sometimes criticised for not saying much, or being vague, but investors can use them to articulate further questions. One of the overarching objectives of introducing KAM in the UK was to help investors and companies to start a dialogue. Whether that dialogue has actually happened, is a moot point.

13. Informal outreach suggests that the introduction of KAM in the UK made little perceptible difference to analysts' reports, mainly because KAM revealed little that was not already clear from diligent study of the financial statements. The risks auditors are required to focus on under both the UK and US regimes focus less on the risks to the business - which is what analysts seek to understand - and more on the risks to the financial statements and, in the UK, risks relating to the audit.

14. UK auditors have very recently started to say more about how some of their other duties have been undertaken, in relation to going concern and viability, for example. However, this relies on auditor responses to company reporting requirements that are not present in the US regime.

Question 3. If you are an investor, analyst, or other financial statement user who has read CAMs for multiple public companies, did you find some CAMs to be more useful than others? If so, what were the factors that made them more useful?

15. For CAM and KAM to be useful, they need to be entity-specific. They have little value if they are written in such general terms as to be potentially applicable to any entity. Furthermore, it was suggested to us that even if they are entity-specific, to have real value, CAM and KAM need to involve some discussion on the auditors' view of the position taken by the company, and/or the auditor's findings. A focus on areas such as goodwill or intangible assets is appropriate, but investors already know that such areas are uncertain, and make their own estimates. Specific issues identified by auditors that may impair goodwill or the valuation of, say, acquired customer relationships, are interesting, but many auditor reports are couched in generalities and such issues are generally covered in detail in the financial statements themselves.

16. The value in KAM at present seems to lie in highlighting areas for further investigation, that might have been taken as read, and might not have been investigated otherwise - tax and revenue being examples. But the KAM themselves are of limited value because of scoping constraints.

    'Being told that revenue is an issue - well that's a shock - and that auditors are not certain about management's expectations as to future proportions of revenue, retention rates or degree of completion of projects - well that isn't usually that helpful, either.' Investor

    'Where there is an issue of significant management estimates, more specific detail of one or two key assumptions and some scenario analysis or comparison to market practice would be invaluable. Auditors need to be encouraged to be less cautious, particularly now.' Investor

Questions for preparers, audit committee members, and auditors

Question 4. Have preparers and audit committees experienced any changes in the financial reporting process as a consequence of CAM communications in the auditor's report? For example, has the communication of CAMs led to changes in controls or practices around financial reporting and disclosure? Did CAM communications result in any reconsideration of, or changes to, disclosures management made in company filings (e.g., notes to the financial statements, critical accounting estimates, MD&A, or risk factors)?

17. Preparers and audit committees have not experienced significant changes in the financial reporting process or controls as a consequence of CAM communications in the auditor's report. However, UK firms dealing with US FPIs are still navigating these changes and we understand that companies are changing emphases and nuance in their disclosures, as a direct result of how auditors report CAM.

    'There are some enhancements at the front end of the annual report regarding assumptions and judgements relating to estimates and disclosures - but no massive overhauls to the financial reporting process.' Auditor

18. Some KAM reported in the UK accordance with ISA 701 do not meet the PCAOB's definition of CAM**.** This lack of alignment makes it important for auditors and others to understand where and why there are differences. This situation is not ideal and while larger firms all manage the differences on a global basis by means of global reporting teams and quality management processes, others are clear that they also seek to minimise the differences.

19. This is particularly true of UK FPIs with new listings whose auditors report on both CAM and KAM for the first time in the same audit. Additional information has often been included in the financial statements in such cases when management becomes aware of the nature of the CAM and KAM to be reported: the disclosure of assumptions under IAS 36 and critical accounting estimates and key judgements under IAS 1 are examples. This has indirectly given investors more information than they would have had otherwise, but it is not clear that this information is provided only as a result of the audit.

Question 5. Have CAM communications had any impact on how audit committees approach their role and responsibilities?

20. There is a good degree of correlation between UK KAM and US CAM. In both cases they often represent risks or estimates that have been discussed with audit committees for many years. For this reason, there have been few if any changes to roles and responsibilities. However, it would also be helpful to investors if audit committees were to set out more clearly what they have done in relation to the issues identified by auditors. In the UK, the UK Corporate Governance Code requires audit committees to report on 'significant issues', and the quality of reporting by audit committees is relevant to this debate.

Question 6. Have auditors or preparers experienced any changes in a specific audit because of CAM requirements? For example, were there changes to the nature, timing, or extent of audit procedures performed on matters identified as CAMs, not because of changes in circumstances but because of CAM requirements?

21. Any enhanced or extended form of auditor reporting represents enhanced risk to the audit firm because of the enhanced visibility of the associated risk assessment process and audit response. However, there has been little change to the audit approach as auditors have always dealt with the matters reported under CAM and KAM, the reporting of which is essentially a by-product of the audit.

Question 7. Did CAM requirements lead to changes in communications between auditors, audit committees, or preparers? For instance, were there changes in the nature or frequency of communications during the audit process? Did audit committee members ask more or different types of questions? Was there more focus on matters that were identified as CAMs?

22. For those FPIs that are dual-listed, auditors have often already communicated with audit committees on the subject matter of CAM, albeit under the UK KAM regime. For them, there

has been little change in the focus of auditors, audit committees and preparers, except as described elsewhere in this response. However, in some cases audit committees have asked more questions, particularly around the need for additional disclosure, such as those relating to assumptions, judgements and estimates. For FPIs that are only listed in the US, while it may be too early to draw any definitive conclusions, matters identified as CAM would already have been discussed with the audit committee as they relate to significant risks, critical estimates, and significant unusual transactions.

23. There are also ongoing discussions about understanding the differences between the identification and drafting of CAM and KAM, and about the cost and value of operating different regimes. All auditing standard-setters need to explore how the private communications between auditors and audit committees can be better and safely communicated to investors and others. Standard-setters should also seek to align the requirements to a greater extent than they have to date.

Question 8. Based on your experience as a preparer or auditor, what were the most significant activities that led to CAM-related costs? First, please describe each activity, including any preparatory activities (e.g., pilots or dry-runs). Next, please estimate the total costs related to CAM requirements in hours (and external spend, if applicable) for each of those activities for each calendar year from 2017-2019 and the period January-April 2020, distinguishing, to the extent possible, between costs related to preparatory activities and costs related to recurring activities. Finally, for any activities that will be recurring, state whether you believe the costs will increase, decrease, or not change for each activity in future years.

24. CAM-related costs include time spent across the firm on training, monitoring, and review processes. In addition, there are engagement-specific monitoring and review costs, and costs relating to research, drafting, consultation and communications. 200-500 engagement specific incremental audit hours for a large audit were suggested to us, depending on the number and complexity of CAM and the associated burden of communication. It was also suggested that 50-80 per cent of engagement specific hours will recur, most of them involving senior staff, but that this will depend the quality of reporting and on how successful auditors are at managing the issues reported and trends in reporting. The coming reporting season seems likely to involve more reporting of KAM and CAM but there are other financial reporting trends that affect auditor reporting, as well as trends in auditor reporting per se.

25. The long term value of KAM and CAM depends on the quality of auditor reporting. The repetition of KAM or CAM year on year is of limited value to investors, but to the extent that there is little or no change, this is hard to avoid. KAM in the UK have evolved. There are new and different KAM identified, some of them less directly related to the financial statements, such as those relating to IT systems or climate change. This type of KAM is of increasing interest to investors. We encourage the PCAOB to consider its own analysis of the differences between reported CAM and KAM under different regimes, and engage with US investors on those differences.

Question 9. From your perspective as an auditor or preparer, at which stages of the audit process did most of your activities related to CAMs occur? Did the majority of your effort occur before or after the company's fiscal year end? What factors contributed to the timing of your efforts related to CAMs?

26. Factors contributing to the timing of CAM efforts include the availability of training and the appetite of audit committees for an understanding the differences between CAM and KAM, and their willingness to consider draft CAM.

27. In practice, UK auditors start with prior year issues that remain relevant together with newly arising current period issues. For larger audits, auditors generally consider issues that may be relevant in the current period, including significant risk areas which may become CAM, between Q3 and Q4. They start drafting shortly prior to the end of the reporting period. For UK KAM, consideration happens slightly later because only then does it become apparent which areas are likely to have involved the most audit effort.