



PCAOB INVESTOR ADVISORY GROUP RECOMMENDATION IMPROVING CRITICAL AUDIT MATTER DISCLOSURES

BACKGROUND & OVERVIEW

The Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group (IAG) met on June 7, 2023, and held a session devoted to the subject of Critical Audit Matters (CAMs). The purpose was to explore – some three to four years after their required implementation – investor views on CAMs relative to their initial potential. Informally, investors have made observations regarding their view on CAMs in the United States including observations such as the following¹:

- Surveys conducted by the CFA Institute, in advance of the [CAM standard](#), indicated that investors believe audit reports, including CAMs, should provide more comprehensive information about key audit risks. Investors noted that they were particularly interested in understanding how these key risks might affect audit procedures and financial statement items bearing a critical level of uncertainty. However, the reported CAMs have often lacked such informative details.
- Depending on companies fiscal year ends, this three to four year window in which CAMs have been in place, and can be assessed, have (for example) encompassed: 1) the COVID-19 pandemic; 2) significant changes in accounting standards, such as the introduction of new lease and expected credit loss accounting standards; and 3) a rise in inflation coupled with Federal Reserve interest rate hikes, and the expectation of a recession 4) the growing materiality of climate risk. As each has had significant impacts on company operations, investors would have expected these risks and events would have influenced the number and nature of reported CAMS. Surprisingly, CAMs seem to have remained unaffected by these developments.
- Fewer CAMs have been reported than originally expected and dual listed companies' auditor's reports, of the same company include Key Audit Matters (KAMs) that appear to be more informative than CAMs.²
- Some audit committee chairs have questioned whether CAMs reporting is becoming a generic compliance exercise, sometimes resulting in "boilerplate" language provided by the auditor.³

The purpose of the panel was to explore more fully these and other observations on CAMs.

¹ The CAM requirements took effect in June 2019 for audits of large accelerated filers and in December 2020 for all other companies to which the requirements apply. In the Order approving the audit standard, the U.S. Securities and Exchange Commission (SEC) noted:

- "We agree with the Board's objective of providing tailored, audit-specific information and believe it is important for auditors to develop CAM descriptions that comply with the [audit standard] without conforming to an example provided by the Board."
- "[I]t will be important to closely monitor the implementation of the [audit standard], including potentially issuing incremental implementation guidance (if needed), providing PCAOB staff to be available to respond to questions and challenges as they arise, and completing a post implementation review as soon as reasonably possible, including some analysis between effective dates for CAMs. The Commission expects the PCAOB to take such steps."

² The PCAOB's definition prevents an auditor identifying and discussing certain matters, such as 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. A Key Audit Matter (KAM) need not meet certain criteria of a Critical Audit Matters (CAMs), such as: (1) a CAM must relate to a financial statement account or disclosure, and (2) A CAM must meet the PCAOB standards for materiality.

³ Audit committee chairs want to guard against CAMs simply becoming a perfunctory practice or compliance exercise. See PCAOB Spotlight, [2022 Conversations With Audit Committee Chairs](#), September 2023



RECAP OF PANEL PRESENTATION TO PCAOB IAG

The panel was comprised of former PCAOB Chief Auditor, Martin Bauman, and former PCAOB Chief of Staff, Samantha Ross, now with The Washington Campus and AssuranceMark, respectively; Dr. Colleen Honigsberg of Stanford Law School; and Jared Goodman, of Colorado Public Employees Retirement Association.

Martin Baumann

Mr. Baumann provided a history of CAMs, noting that they grew out of the PCAOB's Audit Reporting Model (ARM) project in response to investor concerns. Baumann noted in his remarks: *"Investors felt that the audit was valuable but that they needed to hear more from auditors about the audit than the standard, boilerplate audit opinion which, for nearly a century, was exactly the same report for virtually all companies. Not all financial statement judgements are the same. Not every audit is the same. Yet the boilerplate audit opinion gave no insights to investors about the complex accounting and audit issues the auditor faced."* Critical Audit Matters (CAMs) were developed for this reason.

Paragraph .11 of AS 3101, [*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*](#), defines a CAM as follows:

CAMs are any 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*

Auditors are required per AS 1301, [*Communication with Audit Committees*](#), to discuss issues such as the following with the Audit Committee:

- (1) Any significant matter discussed with management in connection with the appointment or retention of the auditor, including significant discussion on the application of accounting or auditing standards.*
- (2) Overall audit strategy and significant risks identified during the auditor's risk assessment.*
- (3) Significant accounting policies and practices*
- (4) Critical accounting policies and practices*
- (5) Significant unusual transactions*
- (6) Qualitative aspects of a company's accounting, including any bias noted in estimates*
- (7) Assessment of critical accounting policies and practices*
- (8) Conclusions regarding critical accounting estimates*
- (9) Financial statement presentation, including clarity and classification of the information*
- (10) New accounting pronouncements*
- (11) Alternative accounting treatments, including management's selections*
- (12) Matters consulted outside the engagement team (e.g., National Office, Industry or Other Specialists)*
- (13) Going concern considerations*
- (14) Corrected and uncorrected misstatements*
- (15) Disagreements with management – even if resolved*
- (16) Difficulties encountered by the auditor, including unexpected extensive effort required, and*
- (17) Any other matter significant to the audit committee's oversight of financial reporting*



From the aforementioned universe, Paragraph .12 of AS 3101 provides additional guidance for assessing which of these matters should be reported as CAMs, as follows:

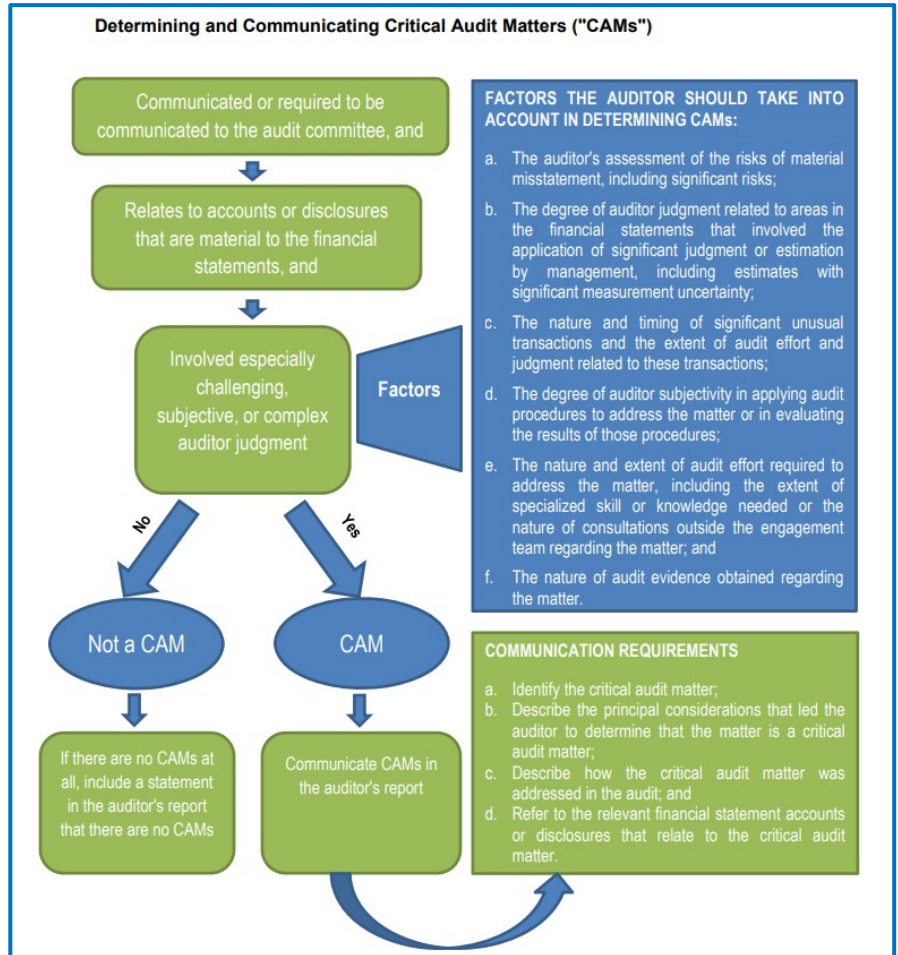
- (a) The auditor’s assessment of the risks of material misstatement, including significant risks;
- (b) The degree of auditor judgment related to financial statement areas involving significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- (c) Significant unusual transactions and the extent of related auditor audit effort and judgment;
- (d) The degree of auditor subjectivity in applying audit procedures;
- (e) The nature and extent of audit effort required to address the relevant matters, including the extent of specialized skill or knowledge (e.g., Specialists) needed or Consultations made outside the Engagement team (e.g., Specialists, National Office, etc.); and
- (f) The nature of audit evidence obtained regarding the matter (e.g., Level 3 fair values having minimal or no external validation sources)

See box to the right with a flowchart highlighting how to determine and communicate a CAM.

Based on the significant universe of matters that the auditor must explore with audit committees, and the guidance for assessing those issues for CAM reporting, investors expected far more robust CAM reporting than has been observed. Academic research is somewhat limited but has shown about 1.5 CAMs disclosed in large firm audits. It appears auditors are comfortable in disclosing what others have disclosed – a sort of herding effect.

Quoting Baumann:

“Expectations were high for significantly more informative audit reports for investors to use in analyzing their investments. If investors’ expectations are not being met – and most indications are that they are not – either compliance with the standard has to be addressed by the PCAOB or the standard has to be modified.”





Baumann proposed the following actions to increase the number and quality of reported CAMs:

- **Audit Profession Rethink of CAMS** – The Audit Profession, or each audit firm, should rethink their approach to the disclosure of CAMs for investors and make significant improvements.
- **Focus on CAMs as Part of Inspections** – Establish an intensive focus by PCAOB Inspections on CAM compliance. The Inspections Division has all the tools they need to establish whether the auditors are following the CAM reporting standard and to require compliance if they are not following it. If compliance is found, then the PCAOB should consider revising the standard.
- **Remove Term “Especially”** – If noncompliance is not the issue, then the wording requiring disclosure of critical audit matters may need to be revised. The phrase “especially challenging” in the CAM definition may be signaling to auditors that only one or two CAMs are sufficient, which was not the intention of the PCAOB. Baumann suggested the following revision, which excludes the “especially” term:

CAMs:

- (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*

He believed that the use of “more” rather than “most” was less limiting in terms of the number of CAMs to report. The IAG members note that one might argue that challenging needs no modifier. If it is challenging, it should be disclosed.

- **Study IAASB KAMS** – Baumann also suggested that the PCAOB should study the experiences of the IAASB’s K-KAMs disclosures. If they are proving more useful for investors than PCAOB C-CAMs, adopting the IAASB definitional language might also be considered.

Samantha Ross

Ms. Ross’s remarks focused on an example of a high-quality K-KAM. She reviewed Glencore Plc’s 16-page auditor report which included six key audit matters spanning nine pages. She made the point that “*observations by auditors are not separate opinions but are investor-helpful points of emphasis*”. Further, she noted that management’s might not necessarily want to see such observations and might resist their disclosure, but their presence reinforces the apparent independence of the auditor. Instead of a mere statement that the auditor was independent, CAMs provide proof. Ross also noted that non-US firms have more KAMS than US companies have CAMs.

IAG member Hal Schroeder raised objection noting concerns of “incremental cost” that is attributed to the increase in KAMS.

Jared Goodman

Mr. Goodman has found that CAMs are written in a legalistic manner and are not very stylistically different from the risk factors section of MD&A. He has found that this style limits their effectiveness in conveying meaningful information. Like other investors, Goodman had hoped that CAMs would reduce investor expectation gaps, educate investors and improve audit quality. In practice, he has observed limited impact on the broader investor community, with CAMs not generating many questions or discussion among investors. Consistent with other panelists, Goodman believes there is a need for better disclosure and for investor opportunities to engage with auditors through CAMs. He also noted that he believes there is a negative connotation associated with CAMs, leading to a preference for less disclosure by both auditors and management. He noted he believes the auditor perception of CAMs is inconsistent with their intended purpose, that being they are a communication device for reaching investors with information about the audit.

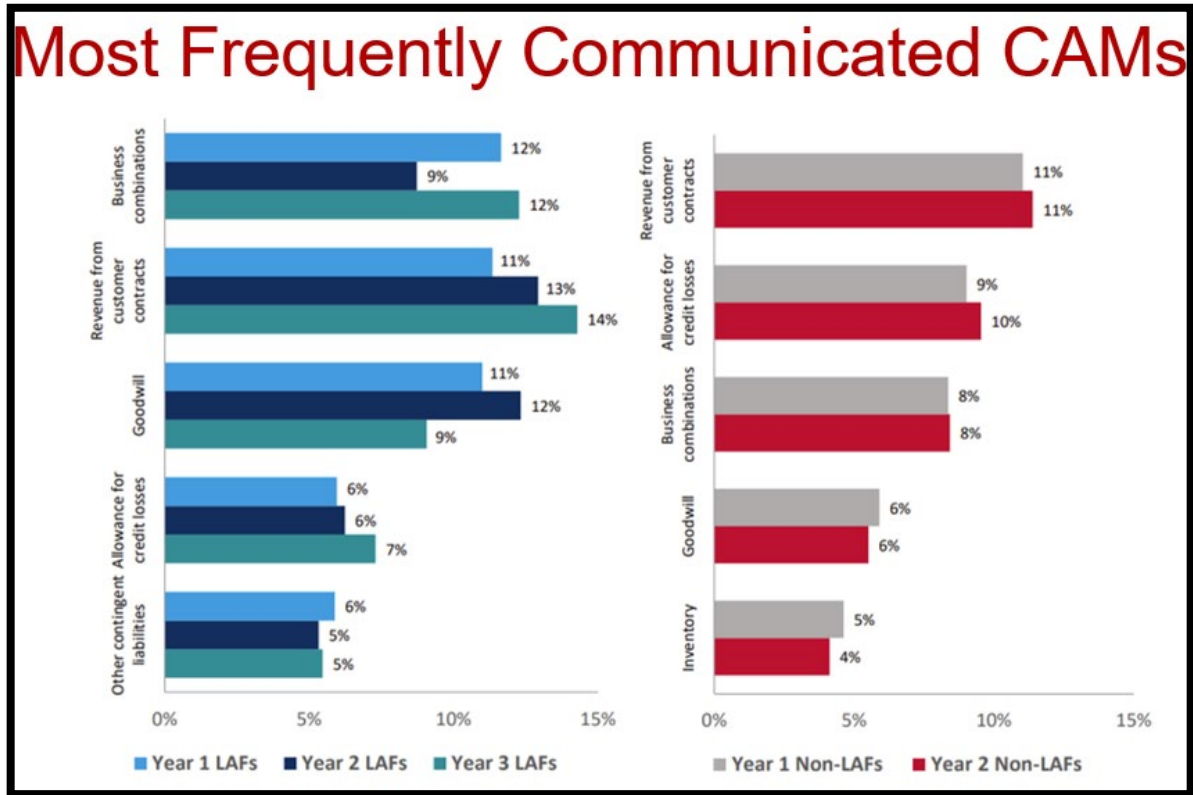


IAG member Gina Sanchez commented that auditors need to be held accountable for CAMs and there is also a need for improvement in the accessibility of audit reports and CAMs. IAG member Gary Walsh added that CAMs don't get traction with investors because they're not easily available in machine-accessible form. As an example, he cited Bloomberg, where you can find 1,500 ESG distinct factors, but nothing on CAMs.

Dr. Colleen Honigsberg

Dr. Honigsberg presented a discussion of findings from PCAOB studies and academic literature. Among them:

- The average number of CAMs per audit report has declined over time (from 1.69 to 1.43 for large accelerated filers (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%).
- As shown in the graph below, large accelerated filers tend to have CAMs clustered in a few categories. Those categories have shifted somewhat over the years of reporting, but the clustering effect is consistent, suggesting “herding” by the auditors.



- 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).
- 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.
- There's a disconnect between these empirical studies and experimental work showing that “investors” change their investment decisions based on CAMs.



- 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.
 - 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. represent the full set that should be disclosed.
- To better understand whether the CAMs disclosed address the accounting and auditing issues important to investors, a compilation was made of accounting and auditing related issues listed in all reports of short-sellers Muddy Waters and Hindenburg over the past year. These issues were compared to CAMs for the same companies. There was zero overlap.
- While short seller reports are not a perfect proxy for investor interest, the lack of any overlap raises a question regarding the utility of CAMs and whether they address the most critical issues for investors.
- CAMs may be particularly important for distressed firms, so she examined 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 Emerging Growth Companies.
 - There appeared to be confusion over the overlap and interaction between the CAM and Going Concern language.



OTHER MATTERS

The March 18, 2019, Staff Guidance, [Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs](#) provides, as the name implies, implementation guidance regarding the determination of CAMs. The first question in the Staff FAQ asks: *How should the auditor apply the requirement to determine matters that involve “especially challenging, subjective, or complex auditor judgment”.*

The response notes – as highlighted in yellow in the box to the right – that the word “especially” instead of “most” as originally proposed was included to convey more clearly that there could be multiple CAMs and that matters are assessed on a relative basis within the specific audit.

We noted, however, that this staff guidance language with respect to CAMS being “assessed on a relative basis” within the specific audit was not included in the 2017 Final Release, [The Auditor’s Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion](#), in either the discussion preceding the actual standard, in the Final Release, or in the actual standard in the appendix to the Final Release.

Further, we note the language in Paragraphs .11 and .12 (see box on next page) – of the actual standard in the 2017 Final Release – regarding the determination of a CAM refers to the assessment of “a matter” and makes no mention of – after making the assessment of each matter against the factors in Paragraph .12 – making a relative assessment of the CAMs within a specific audit.

We note the [2016 reproposing release](#) (page 21) used the language included in the March 2019 Staff Guidance in a discussion of the move to “especially” from “most” because there was concern that use of the term “most” would result in only one CAM.

Staff FAQs

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

CAMs stand out from the other numerous matters addressed during an audit due to the challenging, subjective, or complex auditor judgment they require. Some aspects of an audit are inherently more challenging, subjective, or complex than others and are therefore more likely to meet the criteria for CAMs when they arise. Other aspects of an audit may involve especially challenging, subjective, or complex judgment only in the context of a particular issuer, transaction, or circumstance.

“Especially challenging, subjective, or complex auditor judgment” is assessed in the context of the many judgments the auditor makes in the course of conducting the audit. The standard uses the word “especially,” instead of “most” as originally proposed, to convey more clearly that there could be multiple CAMs and that matters are assessed on a relative basis within the specific audit.

For example:

A matter that was a CAM in a previous period would not cease to be a CAM just because another matter arose in the current period requiring even more challenging, subjective, or complex auditor judgment. If both matters involved especially challenging, subjective, or complex auditor judgment in the current year, the auditor would identify both as CAMs.

In determining CAMs, the auditor should consider each of the criteria in the CAM definition: a CAM may involve especially challenging auditor judgment, especially subjective auditor judgment, especially complex auditor judgment, or some combination thereof.

When communicating CAMs, auditors may choose to identify specifically which of the three criteria apply to each CAM. However, labeling a matter as “challenging,” “subjective,” and/or “complex” does not substitute for the required description of the principal considerations driving the CAM determination. That description should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter is a CAM—i.e., what especially challenging, subjective, or complex auditor judgments were involved in auditing the matter.



However, making an “especially” assessment relative would result – and we believe in practice may be resulting – in the identification of only one CAM. To make the “especially challenging” characteristic comparative, or relative to other CAMs within an audit, means the auditor is seeking to arrive at the “most” challenging CAM – which was the purpose of removing the term most, as it would result in only one CAM.

We also note that we cannot find any guidance within the actual final standard that calls for a relative or comparative assessment of CAMs to determine which item is especially challenging. Given that comparison across CAMs could be quite difficult – given the underlying audit risks can be quite different – we would have expected this to be a step outlined in the paragraphs in the standard.

For this reason, we believe the PCAOB should consider the following:

- **Revise Staff Guidance** – We believe the PCAOB needs to revise the Staff Guidance because:
 - 1) The discussion of making a relative analysis was not included in the discussion section of the final release approved by the PCAOB or SEC.
 - 2) The actual standard makes no reference to a relative analysis of CAMs and provides no guidance on how to perform such an analysis.
 - 3) The actual standard focuses on the specific evaluation of “the matter” or “a matter” – singular – against the criteria in the standard In Paragraphs .11 and .12.

Critical Audit Matters

Determination of Critical Audit Matters

.11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter 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: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are not a substitute for the auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105).

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

- a. The auditor's assessment of the risks of material misstatement, including significant risks;
- b. 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;
- c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
- e. 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
- f. The nature of audit evidence obtained regarding the matter.

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

- **Inspection Process Review** – We also believe the PCAOB, as part of the inspection process, should consider whether there is a relative assessment process being used or applied by auditors in deciding which matters represent a critical audit matter.

Investors never sought for auditors to make a comparison between “a matter” to determine which single item was the most especially challenging. Rather, the spirit of the standard was to look at the universe of matters and disclose those which were challenging to audit and which investors would like to know more about.



RECOMMENDATIONS

The consensus of the Investor Advisory Group is consistent with the observations of the panelists: CAMs should provide investors with useful information about the highest risk areas the auditor encounters in their annual examination, but in practice, the reported CAMs have fallen short of their intended purpose.

To stimulate both the number of reported CAMs and their robustness, the recommendations of the PCAOB Investor Advisor Group are as follows:

- **Revise Staff Spotlight to Remove Guidance (Which May Tend to Restrict Declaration in CAMS) Not Included in the Standard** – We believe the PCAOB needs to revise the Staff Guidance to remove any reference to *“and that matters are assessed on a relative basis within the specific audit”* as the actual standard does not include a requirement that matters are to be assessed on a relative basis. We believe it is necessary to clarify that “a matter” is considered with respect to the factors outlined in Paragraph .12 of the standard – not relative to other matters being considered for determination of whether a CAM exists.

From our discussion it seemed clear that those who were originally involved in the development of rules for CAMs had not expected or intended that they be so limited. Clarification by the PCAOB on the language above may be helpful to those charged with implementation to follow the intent of the rules.

- **Focus on CAMs as Part of Inspections: Issue an Inspections-Related Board Report and Statement** – We encourage the PCAOB inspection and enforcement staff to evaluate whether or not audit firms are complying with the CAM audit standard generally or broadly. We also believe the PCAOB should specifically evaluate whether CAM determinations are being made on a relative rather than absolute basis based upon a separate assessment of each matter against the factors in the standard.

We believe the PCAOB should execute, through a large-scale examination of audit workpapers, an inspection and report on how CAM determinations are being made and documented.

Auditors’ workpapers should document communications with the audit committee, the identification of CAMs and their evaluation. The inspections staff has a unique ability to look across companies and firms to assess how the standard is being implemented and identify cross-cutting thematic issues regarding the operational effectiveness of the standard that may be preventing effective disclosures to investors. More specifically, the PCAOB inspections team has the information to evaluate whether one CAM for most audits is a reasonable conclusion based upon the actual words and spirit of the standard.

The PCAOB should not only describe deficiencies in each firm’s individual inspection report but also prepare a report sharing the results of its review in an [Inspections-Related Board Report or Statement](#).⁴

- **Remove Term “Especially”** – Whether or not such an examination indicates compliance, we recommend that AS 3101: [The Auditor’s Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified](#)

⁴ See for example, [Inspection Observations Related To PCAOB Rules And Auditing Standards On Communications With Audit Committees](#), Apr 2016, at [Inspections-Related Board Reports and Statements | PCAOB \(pcaobus.org\)](#)



Opinion, the PCAOB should promptly revise the “especially challenging” language used in the standard for identifying potential CAMs. We believe that this language may actually discourage auditors from issuing potential CAMs. We note the language suggested by Mr. Bauman to change to “more challenging” or “most challenging”; however, we would argue that challenging needs no modifier. If is challenging, it should be disclosed. We would prefer the standard simply refer to “challenging matters.”

We also believe that if a relative analysis of CAMs is not to be made, this should be noted in the standard and we believe if there was an intent to make a relative analysis within a specific audit that this should not be the case.

- **Describe the Auditor’s Observations, Not Simply Their Audit Procedures** – It was noted, by Mr. Mahoney, during the discussion at the IAG that Paragraph .14 – with special attention of Paragraph .14 (c) – of AS 3101, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* states:

For each critical audit matter communicated in the auditor’s report the auditor must:

- a. Identify the critical audit matter;
- b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- c. Describe how the critical audit matter was addressed in the audit; and

Note: In describing how the critical audit matter was addressed in the audit, **the auditor may describe**: (1) the auditor’s response or approach that was most relevant to the matter; (2) a brief overview of the audit procedures performed; (3) an indication of the outcome of the audit procedures; and (4) key observations with respect to the matter, or some combination of these elements.

- d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.

It is important to note the words, “the auditor *may* describe” in the note following Paragraph .14(c) places no obligation on the auditor to report on the observations or findings with respect to issues that are of most interest to investors. This may contribute to the lack of information being provided by the current CAM reporting. We suggest that Paragraph .14(c) be revised to incorporate the note as a part of the standard and eliminate the optionality of “may”. We believe Paragraph .14(c) should be revised as follows:

- c. Describe how the critical audit matter was addressed in the audit; and in describing how the critical audit matter was addressed in the audit, **the auditor *must* [emphasis added] describe**: (1) the auditor’s response or approach that was most relevant to the matter; (2) a brief overview of the audit procedures performed; (3) an indication of the outcome of the audit procedures; and (4) key observations with respect to the matter, or some combination of these elements.

- **Outreach to Investors** – The IAG also recommends that the PCAOB’s Office of Research and Economic Analysis undertake a large outreach program including a wide variety of investors. The objective would be to gather evidence regarding any CAMs that investors have found particularly insightful or useful, and to gauge investor expectations of CAM disclosures. The information from such a program could help the PCAOB formulate improvements to the CAM requirements.



Members of the Investor Advisory Group

- **Research on Matters of Importance to Investors** – We also recommend the PCAOB commission research by academics which would explore topics of interest to investors and how they stack up against CAMs currently presented – including an analysis of why the issues of interest to investors were not consider CAMs despite appearing complex to audit.
- **IAG Annual Evaluation of CAMs** – Finally, several IAG members have suggested that, on an annual basis, the PCAOB IAG publicly solicit nominees for best CAMs – perhaps after input from PCAOB’s Inspections and Enforcement staff as well as staff within the Office of Research and Economic Analysis – and identify three CAMs that the IAG members believe are particularly insightful or useful to investors. Those three CAMs would then be included in an annual IAG public report which includes an explanation as to why the three CAMs were viewed by the IAG to be particularly insightful or useful to investors. The report could also include recognition of and comments from the engagement partners that were responsible for the winning CAMs. Among the many benefits of this recommendation is that it is a carrot, rather than a stick, and will likely be supported by the firms, and can be implemented this year.