Audit Committees: The Proposed Disclosure of Critical Audit Matters
Robert F. Dow

In August 2013, the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) issued a proposed audit standard which, among other items, would require auditors of public companies to report “critical audit matters” in their audit opinion letters. The nature of the critical audit matters is described further below, but in summary they would include items which may be sensitive and problematic for the company. This requirement would raise many concerns for audit committees. Although the final standard has not been adopted, audit committees should begin considering their response to this expanded disclosure.

The Proposed Standard

The PCAOB issued the proposed standard, “The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,” (the “Proposed Standard”), on August 13, 2013. The Proposed Standard followed a concept release on reporting which the PCAOB issued in June 2011, and which was followed by an extensive comment process. The Chair of the Board and several other board members have expressed the view that the audit reporting model should be expanded to provide more meaningful information to investors.

The Proposed Standard includes several changes to the form of the audit report for SEC-reporting companies. The Proposed Standard retains the pass/fail model and the basic elements of the current auditor’s report, but would require the auditor to communicate a wider range of information specific to the particular audit. This expanded information includes:

- Communication of critical audit matters that would be specific to each audit.
- Addition of new elements to the auditor’s report related to
  - Auditor independence;
  - Auditor tenure;
  - Auditor’s responsibility regarding other information that is included in documents containing the audited financial statements and the related auditor’s report.
- Enhancements to existing language in the auditor’s report related to the auditor’s responsibility for fraud and notes to the financial statements.

The description of critical audit matters in the auditor’s report would:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and

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4 Proposed Standard, para. 5.
■ Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.\(^5\)

If the auditor determines that there are no critical audit matters, then the auditor would state in the auditor’s report that the auditor determined that there are no such matters to communicate.

The comment period expired on December 11, 2013. The PCAOB has received over 230 comment letters, which is not surprising given the scope of the changes.\(^6\)

**What Are Critical Audit Matters?**

The Proposed Standard defines critical audit matters as those matters addressed during the audit that:

■ Involved the most difficult, subjective, or complex auditor judgments;
■ Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
■ Posed the most difficulty to the auditor in forming the opinion on the financial statements.

Critical audit matters ordinarily are matters of such importance that they are required to be:

■ Documented in the engagement completion document, which summarizes the significant issues and findings from the audit;
■ Reviewed by the engagement quality reviewer;
■ Communicated to the audit committee; or
■ Any combination of the three.

According to the Proposed Standard, the auditor should consider the following factors in determining critical audit matters:

■ The degree of subjectivity involved in determining or 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.
■ The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence.
■ The severity of control deficiencies identified relevant to the matter, if any.
■ The degree to which the results of audit procedures to address the matter resulted in changes in the auditor’s risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any.
■ The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any.
■ The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
■ The nature of consultations outside the engagement team regarding the matter, if any.\(^7\)

The above definition of critical audit matters leaves room for broad interpretation. The Proposed Standard does not provide a more specific definition nor does it provide a comprehensive list. According to Board Member Lewis Ferguson,

I support the Board’s approach because I believe it allows auditors substantial latitude to exercise professional judgment in determining what items to include as CAMs but constrains that judgment by an objective standard, the reasonable and experienced auditor looking at the same evidence. This standard is analogous to the reasonable man standard that is well developed in many areas of law to provide an objective standard against which to measure

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\(^5\) Proposed Standard, para. 11.
\(^7\) Proposed Standard, para. 8-9.
individual conduct. Such a standard is also flexible in that it can be expected to evolve over time because it is drawn from the state of knowledge, custom and professional practice at any given time, all of which continuously evolve. It provides a standard that audit firms, regulators like the PCAOB, and others can use to measure compliance with the requirements of the standard. Obviously the proposed standard can only work and be effective if auditors in fact are able to identify CAMs in a consistent way using the criteria set forth in the standard and their professional judgment.8

Several commenters have complained that the definition is too broad or too vague. Some have suggested that the PCAOB should provide additional guidance on the scope of critical audit matters.9

However, given the guidance described above, it is fair to say that most critical audit matters will be items which historically have been identified by the auditors to the audit committee but which have not been publicly disclosed. I recommend that audit committees should begin an internal review of past audit completion memoranda and audit committee minutes to compile a list of potential items that may come up.

Appendix 5 to the Proposed Standard provides three examples of critical audit matters:
(1) allowance for sales returns, (2) valuation allowance for deferred tax assets, and (3) fair value of untraded, fixed maturity securities.

An additional source of potential examples is the Board’s standard on audit committee communications.10 The definition of critical audit matters includes items communicated by the auditor to the audit committee. AS 16 discusses several items which the auditor is required to communicate. Some of those items which may become critical audit matter include:

- The assessment of critical accounting policies and practices.
- Significant unusual transactions.
- Alternative accounting treatments.
- The auditor’s assessment of going concern issues.
- Uncorrected and corrected misstatements.
- Disagreements with management.
- Restrictions placed on the auditor by management.

Some additional examples may include: revenue recognition for complex situations such as multiple deliverables; asset impairments; accounting for derivative securities; significant deficiencies in internal control discovered during the audit; or categories of transactions for which there was a recent significant change in accounting policy. Of course, These examples will not be critical audit matters in all audits. The auditor will select the matters which will be disclosed as critical matters based upon all the criteria discussed in the Proposed Standard.

According to the Release, “[t]he communication of critical audit matters could help to alleviate the information asymmetry that exists between company management and investors. More specifically, company management is typically aware of the auditor’s most challenging areas in the audit because of regular interactions with the auditor …Reducing the level of asymmetry between the company and investors could result in more efficient capital allocation …”11

The Proposed Standard does not limit the definition of critical audit matters to items which are material to the financial statements. At least one commenter has suggested that the PCAOB should revise the final standard to include such a limitation.12

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9 See, e.g., Comment Letters of Financial Executives International (Dec. 11, 2013); Center for Audit Quality (Dec. 11, 2013); and National Association of State Boards of Accountancy (NASBA) (Dec. 9, 2013).
10 PCAOB Auditing Standard No. 16, Communications with Audit Committees (“AS 16”).
11 Appendix 5 at p. A5-23.
12 See Comment Letter of KPMG LLP (Dec. 11, 2013).
The Audit Committee’s Responsibilities for Financial Reporting

The audit committee has responsibility for the oversight of the company’s financial reporting and audits of the company’s financial statements.13 This responsibility is intended to address the quality of the company’s information and not merely the compliance with applicable rules. Because of the audit committee’s duties and responsibilities, it should take a leadership role in addressing any critical audit matters.

Specific ConcernsRaised by the Proposed Standard

Once the critical audit matters are determined for disclosure, the audit committee should oversee the company’s response. Specific concerns and action items include the following.

The quality of the company’s financial reporting and internal control.

Depending on the nature of the critical audit matter, it may call into question the accuracy of the company’s financial reporting or the quality of its application of the applicable accounting standards. The audit committee should make inquiries about, and satisfy itself with respect to, such matters. The committee should be mindful that although the current application of the standards may not have resulted in a misstatement that is material, the materiality of the matter could change over time. The Proposed Standard has a broad definition of critical audit matters which may capture some items that are not really significant to investors. The committee should also assess whether the critical audit matter affects the quality of the company’s internal control over financial reporting.

Communications with the auditor.

The Proposed Standard would place an ever-increasing importance on the quality of communications between the auditor and the audit committee. As defined, critical audit matters will include matters that currently are required to be communicated by the auditor to the audit committee, but may also include matters that do not have that requirement.14 In either case, the audit committee will want to keep an open line of communications with the auditor and will want to inquire of the auditor regarding items the auditor expects may be critical audit matters.15

In a post-Sarbanes-Oxley world, the independence of the auditor has received increasing emphasis.16 The auditor cannot be seen as caving into pressure from the company. On controversial issues, the auditor will not negotiate its position. So what happens in practice is a subtle dance, in which management or the audit committee will communicate their views and make suggestions, and the auditor takes them under advisement and formulates its final position. In the case of critical audit matters, the dance needs to begin as early in the process as possible to allow time for reflection prior to positions hardening on the issue. Generally, if the audit committee is surprised by a critical audit matter that appears in an audit report, there has been a failure of communication and the audit committee (among other issues) needs to reassess its communication process.

Costs and audit quality.

The Release acknowledges that the proposed disclosure requirements will increase costs, and that there is potential for detrimental effects on the audit due to company and auditor distraction or reallocation of resources from the main task of determining the “pass/fail” audit opinion on the financial statements.17 Some commenters have expressed concern about these effects.18 Some have suggested that these effects should lead to the conclusion that the proposal to require the

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14 Proposed Standard, para. 8.
15 See also AS 16. By design, the Proposed Standard overlaps significantly with AS 16, and AS 16 is referenced frequently in the Release.
17 See Release, Appendix 6.
18 See, e.g., Comment Letters of SIFMA (Dec. 10, 2013); Institute of Management Accountants (Nov. 12, 2013); and New York Society of CPAs (Dec. 10, 2013).
disclosure of critical audit matters should be abandoned. Assuming the PCAOB nonetheless retains the requirement, the audit committee will need to have frank discussions about these costs. The audit committee should also inquire of the auditor about the adequacy of resources and expertise assigned to the audit.¹⁹

**Accuracy and completeness of disclosure regard the critical audit matter.**

Some commenters have suggested that the Proposed Standard, if adopted, may result in unhelpful “boilerplate” descriptions of critical audit matters.²⁰ This raises the possibility that the auditor may identify a legitimate critical audit matter, but then give a wholly inadequate description. The company may need to assess whether it should address the matter more fully outside the audit report, in the company portions of the disclosure document. In particular, the audit committee may need to reassess the company’s disclosure in the financial statement footnotes and in the Critical Accounting Estimates section of Management’s Discussion and Analysis of Financial Condition and Results of Operations.²¹

**Investor reaction.**

Closely related to accuracy of the reporting is the potential investor reaction. While I believe that most critical audit matters will not elicit anything more than a yawn from most investors, in deliberating the company’s response the committee should consider the potential effect on investors. Of particular concern would be an overreaction to what amounts to a fairly routine accounting matter. As a preventative measure, the company may want to consider an effort to educate investors more thoroughly about critical accounting matters. For instance, there are some industries where virtually every company may have a critical audit matter concerning revenue recognition or deferred taxes.

**Disclosure of confidential or sensitive information.**

Given the requirements to be placed on auditors to describe the nature and background of critical audit matters, the PCAOB expects that the audit report will disclose new information that has not otherwise been disclosed by the company. The Release gives as examples a deficiency in internal control that does not qualify as a material weakness, a difficult decision regarding the company’s ability to continue as a going concern, or a loss contingency which would not require to be disclosed in the financial statements.²² The details of such matters may be embarrassing to the company or create competitive problems. Potentially, there could be matters to be reported in the audit report that could be confidential or even for which the company may have a duty of nondisclosure. The audit committee will need to discuss such matters with auditors and with counsel.

**Self-assessment of the audit committee’s oversight function.**

Depending on the nature of the critical audit matter, it may call into question the effectiveness of the audit committee’s oversight of the audit function. If the reported matter indicates significant issues, then the committee will need to discuss “what went wrong” and take steps with regard to self-correction. In any event, the committee’s handling of even routine critical audit matters should be considered when assessing the committee’s effectiveness.²³

**Potential liability concerns.**

The reporting of critical audit matters may raise liability concerns for the company and for the directors. I believe that routine matters should not raise the risk profile, but depending on the nature of the reported matter, there could be increased risk for allegations of misstatements on the part of the company or lax oversight on the part of the directors.²⁴

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²² See Release, Appendix 5, Section V.F.2.
To begin to assess the risk, the audit committee, in consultation with disclosure counsel, should discuss with the auditor their view as to the relative significance of the reported matters and whether they are routine within the industry and among public companies of similar size. Auditors may be circumspect about expressing fully their views on these matters, but the audit committee should definitely ask these questions. The company may need to do a self-assessment, comparing its financial reporting standards to its competitors and peers.

The degree of liability for omissions (i.e. matters that arguably should have been reported as critical audit matters) remains unclear. The Proposed Standard does not provide any safe harbor or protection from liability for either the company or the auditor.

**Disagreements with auditors.**

Ultimately, the auditors must come to their own conclusion as to whether a matter rises to the level of a critical audit matter. However, I expect that some matters will be discussed among the auditors, management and the audit committee prior to the issuance of the final report. Management or the committee may not always agree with the auditor on the scope of the reported items. The committee should seek to reconcile the views and come to a consensus in such a way as to avoid a reportable “disagreement” with the auditor.25 Once the final report is issued, the committee should ensure that the company’s communications about the matter do not suggest such a disagreement.

**Misleading the auditors.**

The company may be tempted to try to persuade the auditor that potential matters do not need to be reported as critical audit matters. Any discussions with the auditor about the scope of the critical audit matters will need to be monitored carefully to ensure that no misleading information or analysis is presented to the auditor to try to change its opinion.26

**Conclusion**

Audit committees should begin now to be prepared to address the issues raised by the disclosure of critical audit matters.

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25 See Regulation S-K, Item 304 and Form 8-K, Item 4.01.
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