New England IN-HOUSE

New disclosures for 'CAMs' require counsel's attention

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Reading financial statements just got more interesting.

Starting with fiscal year audits for the year ended on or after June 30, 2019, auditors for large public registrants will be communicating more than the old-fashioned "free from material misstatement" standard audit opinion, and will be producing a new narrative referred to as "critical audit matters," or CAMs.

The CAM disclosures are intended to provide transparency to information shared by auditors with audit committees to enhance the usefulness of the auditor's report and will shine a spotlight on the riskiest aspects of a company's financial reporting.

Certainly, both are major reasons why corporate counsel will have a strong interest in reviewing and scrutinizing what is disclosed by auditors for their clients.

Definition and reporting for CAMs

The guidance for CAMs is promulgated by the Public Company Accounting Oversight Board and reported in AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.

Importantly, the determination for what is a "CAM" is principles-based and depends on the facts and circumstances of each audit; simply put, they are a matter of professional judgment and interpretation.

The PCAOB, in its implementation guide on CAMs, notes that they are linked to "matters required to be communicated to the audit committee — even if not actually communicated — and matters actually communicated — even if not required."

As such, CAMs include matters in which the auditor, during its risk assessment or conduct of audit, deemed the financial account or disclosure to be material to the financial statement and involve especially challenging, subjective or complex auditor judgments.

AS 3101 provides an example list of factors for the auditor to consider when judging whether a matter qualifies as a CAM, including:

- 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 those 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, and any other matters specific to the audit.

More specifically, once identified, the auditor must describe its principal considerations to determine that the matter is a CAM, which, per the PCAOB, "… should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment … [and] should be tailored to the audit to avoid standardized language … ."

Auditors must also describe how the CAMs were addressed in the audit. Per the PCAOB, the auditor may describe any, or a combination, of the following:

- the auditor's response or approach that was most relevant to the matter;
- a brief overview of the audit procedures performed;
- an indication of the outcome of the audit procedures; and
- key observations with respect to the matter.

Importantly, when describing CAMs, the auditor is obligated to provide this information even if such matters have not been previously disclosed by the company.

With any new disclosures, meeting the minimum requirements is essential; the next decision is how much more than the minimum requirement is helpful.

Of significance, the auditor will also be in risk management mode for the disclosures, and the auditor's risks are different than the company's. If the auditor chooses to describe certain audit procedures, the information is supposed to be at a level that financial statement users would generally comprehend and provide a useful summary (e.g., something less than every aspect of how the matter was addressed in the audit).

The CAMs section of the auditor's report will be titled "Critical Audit Matters" and will include the following standard introductory language:

"The critical audit matters communicated below are matters arising from the current period 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) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate."

Finally, CAMs are not a substitute for other required explanatory paragraphs in the auditor's opinion, such as when there is substantial doubt about the company's ability to continue as a going concern or a restatement of previously issued financial statements, among others.

There could be situations in which a matter meets the definition of a CAM and also requires an explanatory paragraph, such as the going concern issue raised above. Cross referencing between the two is acceptable and may avoid redundant disclosures.

However, if a matter that the auditor considers emphasizing meets the definition of a CAM, the auditor would provide the information required for a CAM, and would not be expected to include an emphasis paragraph in the auditor's report.

Considerations for corporate counsel

With regard to the implementation process for CAMs, and in particular the preparation process for the initial disclosures, Wes Bricker, chief accountant for the Securities and Exchange Commission, stated:

"Certainly there are possibilities of material disagreements. We have a system designed to resolve those situations, but it's better to know what those areas are so they can be resolved over the course of preparing the information, so the end product reflects the trio of voices — management, audit committee, and auditors — with as much consistency and clarity as the three can work out."

For context, it's critical for corporate counsel to be aware that auditors are independent from their audit clients, so companies don't control what auditors ultimately do and, in this case, disclose in CAMs.

That said, as auditors work through their initial public disclosures for CAMs, they will be communicating with audit committees and management on the subjects they will be reporting, and all want to collaborate to meet the disclosure requirements and provide useful information to investors.

As important, CAM disclosures won't change the auditor's overall conclusion included in the standard opinion (e.g., that the financial statements are free from material misstatement). The CAM disclosures will highlight the financial reporting areas that are the most risky and describe how the auditor's procedures overcame those risks.

Needless to say, incremental disclosures on risks, while possibly repetitive with a registrant's critical accounting matters or risk factors, still represent a new forum and discussion by a third party.

Sensitive matters that may arise in this process include:

- Will CAM disclosures make the company's prior disclosures appear less than robust or adequate?
- Will companies seek to adjust their disclosures in light of what auditors want to say in the CAMs?
- To what extent will reliance on management representations be part of the auditor's CAMs and will management see this as added/unwanted public exposure?
- Will auditors' presentation of CAMs be interpreted by investors as weakening or strengthening the standard audit opinion?
- Will auditors seek to be over-inclusive to avoid being second-guessed if areas not deemed CAMs are later found to have errors?
- Will trying to limit auditor CAM disclosures be viewed negatively by the auditors and harm the audit relationship?
- Will CAMs migrate to being more industry-based instead of the intended company-facts-and-circumstances-based?
- Will extensive auditor procedures related to CAMs be considered an indication of an internal control problem?
- Will the added discussion raise any sensitive items related to company litigation matters?

So yes, reading financial statements will be more interesting thanks to CAMs, and investors will benefit from the added transparency into the audit process and a company's risks.

As always though, communications that involve the company and may create risks require careful legal review, which is why this de novo process requires corporate counsel's involvement.

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