PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Interim Analysis Report

Further Evidence on the Initial Impact of Critical Audit Matter Requirements

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INTRODUCTION

In October 2020, following the initial implementation of critical audit matter (CAM) requirements by auditors of large accelerated filers (LAFs), the Public Company Accounting Oversight Board (PCAOB) released a report summarizing early evidence on the initial impacts of CAM requirements. This follow-up report discusses recent developments in CAM communications and provides additional insights and PCAOB perspectives following implementation of CAM requirements by auditors of non-LAFs to which the requirements also apply.[1]

To develop this report, staff of the PCAOB's Office of Economic and Risk Analysis surveyed auditors and investors, interviewed audit committee chairs and preparers, and conducted large-sample statistical analysis. Staff also evaluated whether evidence gathered on initial and ongoing implementation of the CAM requirements is suggestive of significant benefits, costs, or unintended consequences.[2]

KEY FINDINGS FROM STAFF ANALYSES

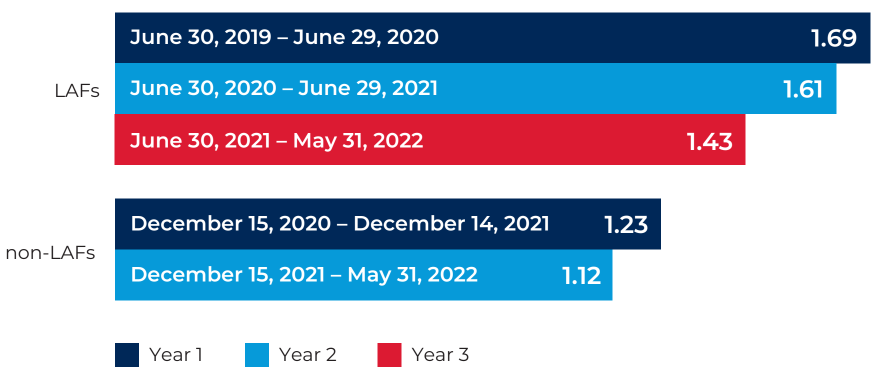
Reports containing CAM communications with **16,429** CAMs

11,599 CAMs per audit report

1.42 CAMs per audit report

Average Number of CAMs per Audit Report

(by fiscal year end date)



- **The average number of CAMs per audit report has declined over time, and the proportion of audit reports that communicate a single CAM has increased.** Also, on average, non-U.S. auditors communicate more CAMs than U.S. auditors, suggesting that firms may have heterogenous approaches to applying their judgement in determining whether a matter is a CAM, perhaps because non-U.S. auditors have greater

[1] The CAM requirements took effect for fiscal years ending on or after June 30, 2019 for audits of LAFs and for fiscal years ending on or after December 15, 2020 for audits of all other companies to which the requirements apply. LAFs are defined by the U.S. Securities and Exchange Commission (SEC) as issuers having a market float of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter. CAM communications are not required for audits of brokers and dealers reporting pursuant to Rule 17a-5 under the Securities Exchange Act of 1934 ("Exchange Act"); investment companies other than business development companies; employee stock purchase, savings, and similar plans; and emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act.

[2] The staff is currently unable to evaluate all possible benefits, costs, and unintended consequences of the CAM requirements, in part because some potential effects may take more time to manifest or stabilize. In addition, results are based on limited data and may not be generalizable to the entire stakeholder population. We encourage interested readers to review the staff white papers that provide additional results and technical detail of the staff's analysis. Further discussion of economic considerations related to the CAM requirements is available in the PCAOB's Adopting Release.

familiarity with determining Key Audit Matters (KAMs) pursuant to the standards of the International Auditing and Assurance Standards Board (IAASB).[3]

- **Investor awareness and use of CAMs continues to develop.** Although results from large-sample statistical analysis do not suggest that investors, on average, respond to the information in CAMs, 80% of investors who read CAMs said that they are using CAMs to identify key financial reporting risks. This suggests that investors may still be learning how to find value-relevance in the information content of CAMs, which adds to the total mix of available information investors use in making investment decisions.[4] Several investors said that they would like auditors to use more specific, rather than generic, language in communicating CAMs and to include in CAMs a discussion of the outcome of audit procedures.

- **All participating firms developed infrastructure and conducted training to support implementation of the CAM requirements by their audit engagement teams; upfront preparation by auditors contributed to a generally smooth experience for issuers, according to the audit committee chairs and preparers we interviewed.** Moreover, among audit firms surveyed in 2020 and 2021, costs incurred at the firm level to support engagement team implementation of the CAM requirements have moderated.

- **Audit engagement partners reported that, on average, audit engagement teams spend 1%-2% of total audit hours on CAM-related activities.** For non-LAF audits, although the staff's statistical analysis finds that initial CAM implementation is nominally associated with increased audit hours and audit fees, evidence from the staff's stakeholder outreach suggests that these costs are not regarded as substantial by auditors and their clients. Auditors of LAFs realized efficiencies in developing and communicating CAMs in the second year of implementation, reporting that they generally spent the same or less time on CAMs compared to the initial year of implementation.

- **The staff has not found evidence of significant unintended consequences from auditors' implementation of the CAM requirements.** The staff does not find that communications between audit committees and their auditors have been inhibited, or that auditors have taken a longer time to issue audit reports.[5]

[3] While the PCAOB requirements to determine CAMs and the IAASB requirements to determine KAMs are similar, there are certain potentially important differences between the standards, such as the PCAOB's requirement that a CAM relate to an account or disclosure that is material to the issuer's financial statements.

[4] While commenters raised concerns during the rulemaking process that CAMs might "duplicate management disclosure without adding additional information, or that critical audit matters would not provide value-relevant information," the Board said that "the reporting of CAMs should provide insights that will add to the total mix of information that could be used in investors' capital allocation decisions." See Adopting Release at 68.

[5] Some commenters during the rulemaking process raised concerns that the CAM requirements could chill communications between audit committees and auditors, or that it could take auditors longer to issue their reports. See Adopting Release at 82 & 89. The Board did not believe that these outcomes were likely, noting that audit committee communications are required under PCAOB rules and that the implementation of expanded auditor reporting in the U.K. did not appear to have caused delays in auditor reporting there. See id.

The Board reminds auditors that they must communicate in their audit reports all matters relating to the audit of the current period's financial statements which meet the definition of a critical audit matter under AS 3101.[6] As stated in AS 3101, it is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.[7] Today's challenging and rapidly-changing macroeconomic environment (e.g., the COVID pandemic, inflation, geopolitical instability) might cause some audit areas to become increasingly challenging, subjective, or complex, which in turn may result in the communication of additional CAMs. In communicating CAMs, auditors are reminded that the intent of CAMs is to provide information about the audit that will be useful to investors and that auditors should therefore provide audit-specific information.[8] The PCAOB will explore opportunities to further increase investor familiarity with CAMs so that investors are able to make use of the information available within CAM communications.[9]

RESULTS IN DETAIL

The staff conducted extensive stakeholder outreach and performed large-sample statistical analyses to inform its evaluation. This section presents findings from the key components of the staff's research. Technical details of the staff's analysis and additional results are available in two staff white papers.

Investor Survey

The staff conducted an investor survey in April/May 2022 to gather information about investor awareness, perceptions, and use of CAM communications. The staff received 53 complete responses from investors who conduct fundamental or governance analysis of companies.

- Investor awareness of CAMs is increasing, with 76% of the investors who completed our survey reporting that they had heard of CAMs, compared to 63% in 2020. Moreover, 57% of the investors who completed our survey had seen CAMs. In the 2020 survey, less than a third (31%) of respondents reported that they had seen CAMs.
- Although most investor respondents agreed that CAMs provided sufficient detail about the audit (60%), less than half of these respondents thought that CAMs were easy to understand (44%) or tailored to the audit (40%). These results correspond to some of the improvements investors are looking for in CAMs in response to an open-ended prompt in the survey.
- Investors who had read CAMs reported using CAMs to, among other things, identify risks associated with a given company (80%), focus on key reporting issues or areas (56%), and better understand disclosures made by

[6] See AS 3101.13. 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.

[7] See AS 3101.12.

[8] See, e.g., Adopting Release at 31 & 70.

[9] The PCAOB has actively sought to educate investors about the information available in CAMs, particularly around the time that CAM requirements first became effective in 2019. For example, the PCAOB issued an investor-specific publication, *Critical Audit Matters: Insights for Investors*, to provide investors with useful information regarding changes to the auditor's report, frequently asked questions about CAMs, and information about the implementation of the standard.

management (60%). These results are similar to the responses reported in the 2020 survey.

- Twenty-four investors responded to an open-ended prompt asking them to share two reasons why they would, or would not, use CAMs in the future.
  - Seventeen of the 24 investors said they would use CAMs in the future. These investors generally found CAMs helpful to identify critical reporting risks and to provide a basis for questions to ask management. Investors also mentioned that CAMs provide insights and clarity on the audit process.
  - Seven of the 24 investors said they would not use CAMs in the future. These investors generally said that CAMs do not add more information to what is already disclosed in other parts of issuers' annual reports (e.g., Risk Factors).
- Twenty-one of the 53 investors responded to an open-ended prompt asking for their perspectives and opinions on how CAMs could be made more useful. These investors suggested that auditors could use more specific and less generic language in communicating CAMs. Some investors wanted to see more detail on the auditor's perspectives of the assumptions made by the company, while other investors mentioned that it would be helpful for auditors to include discussion of the outcome of audit procedures in CAMs.[10]

Audit Firm Survey

A selection of 18 U.S. audit firms, including 10 whose client portfolios consist mainly of non-LAFs, completed a survey in August 2021 on the processes and procedures they developed to prepare for and implement the CAM requirements, including associated costs.[11]

- All eight annually inspected firms[12] that provided data in 2020 and 2021 reported that they made refinements to their CAM-related processes and practice aids following the first year of CAM implementation (e.g., by updating internal guidance and training materials). For the other 10 smaller firms, who are triennially inspected and whose client portfolios consist mainly of non-LAFs, all developed infrastructure and conducted training to support the implementation of the CAM requirements by their audit engagement teams, and some also reported benefiting from the phased implementation of the CAM requirements.
- Among the Big Four firms, through April 2021, the average amount of time spent per firm on firm-level activities to support

[10] Neither of these types of information is required to be included in CAM communications. For example, in describing how a critical audit matter was addressed in the audit, an auditor may choose from among four categories of information, one of which is "an indication of the outcome of the audit procedures." See AS 3101.14(c).

[11] For this analysis, we gathered data from (1) all eight audit firms (the Big Four firms plus four annually inspected firms) that provided data to our first audit firm survey in 2020 that focused on the implementation experience for LAFs, and (2) a selection of ten firms whose clients mostly consist of non-LAFs. In selecting these additional 10, we sought to achieve certain efficiencies by combining our outreach for the interim analysis of CAMs with our interim analysis of the PCAOB's Estimates and Specialists standards. In choosing the additional 10, we considered the extent to which audits conducted by these firms were expected to be impacted by the new estimates and specialists requirements, based on data that these firms had provided in connection with prior PCAOB inspections. We acknowledge that this is not a random sample, and we caution against extrapolating from the results to other audit firms in the market that fall outside the scope of this research.

[12] Under the Sarbanes-Oxley Act of 2002 and as explained in detail in PCAOB Rule 4003, the PCAOB inspects annually those registered public accounting firms that issue audit reports for more than 100 issuers, while those that issue audit reports for 100 or fewer issuers are inspected at least once every three calendar years.

implementation of the CAM requirements was 26,300 hours (54% at the partner level),[13] while the average amount of total time personnel spent attending CAM-related training per firm was 15,500 hours (30% at the partner level). The majority of this time was incurred before 2020.

- Among the other four annually inspected firms providing data, through April 2021, the average amount of time spent per firm to support implementation of the CAM requirements was 4,400 hours (45% at the partner level), while the average amount of total time personnel spent attending CAM-related training per firm was 3,900 hours (24% at the partner level). As with Big Four firms, the majority of this time was incurred before 2020.
- Among the 10 smaller firms that participated in our survey, through April 2021, the average amount of time spent per firm to support implementation of the CAM requirements was 700 hours (74% at the partner level), while the average amount of total time personnel spent attending CAM-related training per firm was 1,100 hours (46% at the partner level). Some of these firms reported benefitting from the phased implementation of CAM requirements.
- Differences in time spent by audit firms to support CAM implementation and train firm personnel reflect differences in underlying audit client portfolios. Big Four firms have an average of 818 issuer clients; the other four annually inspected firms that participated in both the 2020 and 2021 outreach have an average of 181 issuer clients. The 10 smaller participating firms have an average of 139 issuer clients.[14]
- Of all firms responding, some reported implementation challenges with ensuring completeness of documentation related to the determination of whether each matter communicated to the audit committee was a CAM.[15] Other firms reported that engagement teams experienced challenges in drafting clear, concise, and useful CAMs. These firms generally provided further assistance (e.g., drafting guides) and support (e.g., CAM subject matter experts/quality reviewers) to assist engagement teams in communicating informative CAMs.

Engagement Partner Survey

The staff conducted a voluntary survey in June/July 2021 of engagement partners at the 18 audit firms that participated in the firm survey. The survey asked for information about the experiences of engagement partners in implementing the CAM requirements for audits of LAFs and non-LAFs which were subject to CAM requirements. The staff received 920 complete responses to the survey.

[13] Hours reported here are estimated by the firms and include time spent: (1) developing, implementing, and revising firm-level audit policies, procedures, methodology, tools, guidance, review processes, and other infrastructure directly related to CAMs, (2) developing training directly related to CAMs, (3) engaging in CAM-related discussions or consultations with engagement teams (if hours were not charged to individual audit engagements), and (4) monitoring implementation of the CAM requirements by individual engagement teams (if hours were not charged to individual audit engagements). Hours do not include time recorded at the individual engagement level (e.g., engagement team hours spent on CAMs, national office hours spent on CAMs and recorded at the engagement level).

[14] Data on the number of issuers is based on Form AP filings for issuers with fiscal year end between April 1, 2020 and March 31, 2021.

[15] PCAOB standards (AS 3101.17) require auditors to document — for each matter arising from the audit of the financial statements that (a) was communicated or required to be communicated to the audit committee, and (b) relates to accounts or disclosures that are material to the financial statements — whether or not the matter was determined to be a critical audit matter and the basis for such determination. Consistent with the requirements of AS 1215, *Audit Documentation*, the audit documentation is required to be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the determination made to comply with the provisions of AS 3101.

- In 2021, engagement partners reported that, on average, about 1.1% of total audit hours were spent identifying, developing, and communicating CAMs for LAFs in the second year of implementation, about the same amount as in the first year of implementation. Auditors of LAFs also realized efficiencies in identifying, developing, and communicating CAMs in the second year of implementation. When asked how time spent on CAMs changed compared to the prior year's audit, a large majority of LAF engagement partners we surveyed reported that it decreased (50%) or stayed the same (34%). Engagement partners for non-LAF audits reported that 1.6% of total audit hours were spent on CAMs in the first year of implementation.

- Responses from engagement partners conducting audits of non-LAFs were generally similar to responses received in the 2020 survey of engagement partners of LAF audits. For the initial audit where CAMs were required to be communicated, 3% of engagement partners of LAF audits and less than 1% of engagement partners for non-LAF audits reported making changes to audit procedures due to the CAM communication requirements. Additionally, among LAF audits, 41% of the engagement partners said that CAM requirements enhanced communication with audit committees, and 58% said that the requirements had no substantive impact on audit committee communications. Among non-LAF audits, those percentages are 32% and 66%, respectively. Around one-fourth of engagement partners reported that the issuer made changes to financial statement disclosures or other corporate reporting because of the CAM communications (25% of LAF audits and 23% of non-LAF audits). Most of these partners indicated that issuers either enhanced their disclosures by providing more detail or made minor wording changes to better align disclosures with CAMs.

Audit Committee Chair and Preparer Interviews

Between September 2021 and March 2022, the staff conducted in-depth interviews of 12 audit committee chairs and nine financial statement preparers (whose titles included Chief Financial Officer, Chief Accounting Officer, and Controller) from a total of 13 audit engagements (representing audits of four LAFs and nine non-LAFs). The interviews provided insight regarding issuer experiences with CAM implementation.[16]

- Audit committee chairs and preparers of non-LAFs that were subject to the CAM requirements for the first time in the most recent audit cycle generally reported similar experiences as audit committee chairs and preparers of LAFs in the initial year of CAM implementation. Auditors of non-LAFs generally began discussions on CAMs in 2019, and a few conducted formal dry runs in preparation for CAM implementation. Audit committee chairs and preparers stated that upfront preparation by auditors, including dry-run programs, contributed to a generally smooth experience for non-LAFs in their auditors' initial implementation of the CAM requirements.

- During the rulemaking process, some preparers and audit committee chairs expressed concerns that CAMs would alter their communications with their auditors. However, those concerns do not appear to have been borne out in practice. Most respondents across both LAFs and non-LAFs asserted that the CAM requirements did not substantively change the nature of their discussions with the auditor,

[16] The PCAOB also contacts audit committee chairs at U.S. public companies whose audits are selected for inspection, inviting them to engage in a substantive conversation covering a range of topics related to oversight of external auditors. In 2021, numerous audit committee chairs reported that CAMs were an important topic of discussion with their auditor. See *Spotlight: 2021 Conversations With Audit Committee Chairs* (March 2022) at 4–5.

although some noted an incremental increase in the level of focus, or attention, around topics designated as CAMs.

- Several preparers stated that they compared planned company disclosures to auditor's draft CAM communications, although none reported making significant changes to company disclosures because of CAMs. Audit committee chairs of some LAFs and non-LAFs stated that CAMs led to in-depth discussions with management over CAM topics, changes to financial statement wording, and ultimately more robust disclosures. Preparers told the staff that CAMs have not driven significant changes to company's financial reporting processes or controls.
- No participants reported receipt of direct investor feedback on CAMs, but some acknowledged that CAMs contain valuable information for investors (e.g., by helping to emphasize significant audit and accounting issues). They generally considered CAMs to have an overall positive impact on the ability of investors to understand and analyze financial disclosures.
- Although preparers reported some costs associated with their auditor's implementation of the CAM requirements (e.g., management time, increased audit fees), almost all stated that such costs were inconsequential.

Large-Sample Statistical Analysis

The staff performed large-sample statistical analyses to investigate the average impact of initial CAM implementation on capital markets, audit fees, and time to issue audit reports on non-LAF audits. These analyses complement, but are not directly comparable with, the survey results discussed earlier in this report.

- The staff's analysis does not find systematic evidence that investors responded to the information content in CAMs – using information from issuers' stock market returns – during the first year of implementation for non-LAFs. This result is similar to the findings for LAFs in the 2020 interim analysis. Overall, these findings are consistent with emerging academic research on the information content of, and market reaction to, CAMs, suggesting that investors may still be learning to apply CAMs to the total mix of information for use in making investment decisions.
- Information on audit fees and audit hours were used to estimate costs of initial CAM implementation for individual non-LAF audits. The staff's large-sample statistical analysis, after examining potential confounding factors, finds a statistically significant increase in audit fees (3.0%) and audit hours (6.6%) for non-LAFs audits following initial CAM implementation. Comparatively, in the 2020 interim analysis the staff found no statistically significant increase in audit fees or hours for LAF audits.[17] Whereas the estimates are statistically significant, they do not appear to be economically large. Results from stakeholder outreach corroborate this view that the implementation costs to issuers were not substantial.
- During the rulemaking process, commenters expressed concern that auditors would take longer to issue reports because of the additional effort required in implementing and communicating CAMs. The staff's large-sample statistical analysis finds no evidence of delays associated with the initial implementation of CAM requirements on non-LAF audits, consistent with the findings in the 2020 interim analysis for LAF audits.

[17] The increase in audit fees and hours for non-LAFs appears to be due to the baseline amount of audit fees and hours required for CAM implementation. Smaller issuers typically have less complicated audits and, therefore, lower overall total audit hours and resulting fees. An increase of audit hours and fees resulting from the communication of CAMs, even of a nominal amount, would proportionally affect smaller issuers more as they have a lower base of audit hours and fees.

WHAT'S NEXT?

The PCAOB will continue to monitor the implementation of CAM requirements and evaluate the timeline for developing the more comprehensive post-implementation review. Because the effects of the CAM requirements may take several years to fully manifest or stabilize, the next analysis will be published no earlier than 2024. Future analyses will further evaluate the benefits and costs of the CAM requirements, including any unintended consequences, to understand the overall effect of the requirements on users of financial statements, auditors, and public companies.