June 15, 2020

Members of the Public Company Accounting Oversight Board

comments@pcaobus.org

RE: Interim Analysis No. 2020-01, Critical Audit Matter Requirements

Dear Board Members:

This letter is in response to the Board's request for comments on Interim Analysis No. 2020-01, Critical Audit Matter Requirements dated April 17, 2020. Specifically, our commentary addresses the question raised by the PCAOB's Request for Comments about how the auditor's work might be impacted by the new standard.

During the PCAOB public outreach period before the adoption of the new standard, audit firms expressed concerns that disclosure of CAMs would expose them to greater litigation risk and associated legal liabilities.[1] Auditors were also concerned that disclosure of CAMs would increase audit costs. On the other hand, investors demanded relevant information about the existence of financial reporting issues and critical matters of the audit process.

We examine these issues as part of a research study. Although the requirements in the standard allow discretion in its implementation, we find that on average, at least one CAM is included in the audit report.[2] Three major takeaways were drawn from our analyses. First, more CAMs are disclosed for clients in highly litigious industries. Second, more CAMs are disclosed for clients

[1] https://pcaobus.org/Rulemaking/Docket034/99b_CAQ.pdf

[2] AS 3101.12 states that it is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

with poor financial reporting quality. Third, the CAM reporting process results in higher audit fees. Overall, it appears that the concerns expressed by audit firms are supported by the data. Auditors are managing litigation risk by disclosing more CAMs while doing so results in greater costs. Since the data only includes the first year of implementation, we are not able to say whether the increase in audit costs is temporary or permanent in nature. On the other hand, the standard seems to be working as intended, as evidenced by more CAMs disclosed when financial reporting quality is poor.

To conduct our analyses, we obtained a dataset from Audit Analytics which included a total number of 2,657 CAMs across 1,682 unique clients for the period June 30, 2019 to February 28, 2020. Research finds that certain industries are systematically more likely to experience shareholder lawsuits.[3] Based on the assumption that auditors will perceive high litigation risk from their association with clients in highly litigious industries, we examine whether there are differences between audit reports for clients in highly litigious industries and clients in other industries. In a sample of 1,258 clients[4], we observe that auditors are about 8 percent more likely to add a CAM for clients in litigious industries. We also observe that the number of CAMs is significantly higher for clients with lower quality of discretionary accruals suggesting that the number of CAMs increases proportionally as the quality of financial reporting decreases. These results suggest that auditors preempt negative consequences from shareholder lawsuits by reporting more CAMs when litigation risk is high. The results also indicate that the standard is working as intended because companies with reporting problems will have more CAMs disclosed.

[3] Francis et al. (1994) classify highly litigious industries as: biotechnology (SIC codes 2833-2836), computers (SIC codes 3570-3577 and 7370-7374), electronics (SIC codes 3600-3674), and retailing (SIC codes 5200-5961). Available at: https://www.jstor.org/stable/pdf/2491279

[4] Due to data availability our multivariate analysis employs only 1,258 clients.

The new standard requires increased disclosures of the most important and critical financial reporting issues that have been discussed with the audit committee for years. This implies that crafting and disclosing CAMs may not necessarily amount to a significant increase in audit costs unless there is a significant increase in the audit process effort. Moreover, many public accounting firms have been conducting dry-runs to prepare for CAMs disclosures; and, resources available from the PCAOB and the CAQ might help auditors to find it easier to prepare the disclosure. Therefore, we examine whether audit costs vary with the number of CAMs. Our results show that audit fees are about 15 percent higher for each additional CAM included in the audit report, suggesting that reporting CAMs requires additional audit effort and the associated costs are passed to clients.

We hope our comments add insight to the Board's interim analysis on the implementation of critical audit matters requirement.

Respectfully submitted,

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