

# ***The CAMs are coming...***

All 6,800 of them



Independent Study Project

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## Preface

I will be starting my second semester as a Junior at the TCU Neeley School of Business in January 2020. I am currently an accounting major and am getting into the bulk of my major related classes.

This will be the third independent study project I have completed over the past year. The first two covered the Sustainability Accounting Standards Board (SASB) and the new lease accounting standard (ASC 842), both of which are available on my LinkedIn profile. Each report has been a valuable learning experience for me. I did this report because I will be taking an auditing class this upcoming semester and **CRITICAL AUDIT MATTERS** (CAMs) are arguably the biggest change to the auditor's report in 80 years, according to a CPA I spoke with.

I would like to thank the PCAOB, CAQ, accounting firms, Shari Katz at Protiviti, Google alerts and several CPA's for helping me with the reference material on CAMs.

During the process of completing this report, I gained a lot of knowledge about critical audit matters and the changes they have made in the accounting and auditing world. On top of that, I have gained other valuable skills, such as:

- Writing and formatting research reports
  - Learning about PCAOB auditing standards
  - How to research a topic like CAMs
  - Understanding the importance of preparation and planning
  - Developing objectives at the beginning of a project
- All of these skills will be very helpful for me as I pursue my accounting major.

***It is my intention that anyone may use and print this report to help them better understand CAMs.***

## Introduction

As I mentioned earlier, I decided to take on this project because of the relevancy of CAMs. First, they are one of the biggest changes to the auditor's report in 80 years. And second, CAMs will provide additional knowledge and context for my upcoming audit class.

In the past, one of the main criticisms of the auditor's report was that it was a pass/fail report that offered no unique or critical information about a specific company's audit.

From all the research I have conducted, I estimate that there will be approximately 6,800 CAMs reported by the auditors of public companies for the 2019 corporate reporting season. See the section entitled *The Math of CAMs* for my calculations, and the section on *The Cost of CAMs* showing calculations on the potential cost of CAM reporting.

As for how CAMs will affect auditors, investors and public companies, it's hard to say at this point. First of all, most public companies' fiscal years don't end until December 31, leaving somewhat limited information on the topic at this time. And since CAMs are a new and emerging area, no one really knows exactly how they are going to affect stakeholders and other users of this information.

Given the fact that a majority of public companies will be reporting CAMs in calendar 2020 for their December 31, 2019 financial statements, I am planning to update this report in a supplement over the summer of 2020.

My conclusions thus far are that CAMs seem to be helpful and informative disclosure for the users of a public company's financial statements. They help to highlight key areas of concern, describe the way the auditor approached the area and additional commentary. This

moves the auditing opinion from a clear pass/fail report to one that is more informative and I think beneficial to financial statement users.

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# What Are CAMs and Who is Requiring Them?

Critical Audit Matters (CAMs) were brought about by the Public Company Accounting Oversight Board (PCAOB). The PCAOB describes themselves as, "... a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of brokers and dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection".

The PCAOB sets auditing standards for the auditors of public companies which are basically instructions about what to audit, how to audit and what to report. This new PCAOB standard on CAMs is known as AS 3101. AS 3101 significantly expands the auditor's report as compared to 2018.

For more information see [www.pcaob.com](http://www.pcaob.com)

The PCAOB defines a CAM as:

## What is a CAM?

A CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that:

- ⦿ Relates to accounts or disclosures that are material to the financial statements; and
- ⦿ Involved especially challenging, subjective, or complex auditor judgment.

The PCAOB describes other important aspects of CAMS, such as communication, documentation and explanatory paragraphs. These descriptions are provided below:

## Communication of CAMs

When communicating CAMs in the auditor's report, the auditor is required to include introductory language in the "Critical Audit Matters" section of the auditor's report.

For each CAM communicated in the auditor's report, the auditor must:

- Identify the CAM;
- Describe the principal considerations that led the auditor to determine that the matter is a CAM;
- Describe how the CAM was addressed in the audit; and
- Refer to the relevant financial statement accounts or disclosures that relate to the CAM.

## Documentation of CAMs

For each matter arising from the audit of the financial statements that:

- (1) Was communicated or required to be communicated to the audit committee; and
- (2) Relates to accounts or disclosures that are material to the financial statements;

the auditor must document whether or not the matter was determined to be a CAM (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.



# CAM Interaction with Explanatory and Emphasis Paragraphs

## CAMs and explanatory paragraphs

CAMs are not a substitute for required explanatory paragraphs. There are circumstances in which the auditor is required to add explanatory language to the auditor's report, 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 going concern.

For these situations, both the explanatory paragraph and the required communication regarding the CAM would be provided, by either:

- Including the required communications for a CAM in the explanatory paragraph, with a cross-reference in the CAM section to the explanatory paragraph, or
- Including both the explanatory paragraph and the CAM communication separately in the auditor's report, with a cross-reference between the two sections. When both an explanatory paragraph and a CAM communication are provided, the CAM description should not include conditional language that would not be permissible in the explanatory paragraph (see [footnote 5 of AS 2415, \*Consideration of an Entity's Ability to Continue as a Going Concern\*](#)).

## CAMs and emphasis paragraphs

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.

## Why CAMs?

CAM's were added to the auditor's report to add more substance to the report. Which means, providing more information to investors to help aid in their investing activities.

Some of the reasons for the requirement for CAMs includes:

- The auditor's report is pass/fail and provides little specific information on the important parts of the audit
- Investors and financial statement users always want more information in helping them to better understand each company related to valuing and evaluating a company

PCAOB heard this and eventually developed the requirements for auditors to report CAMs. See [www.pcoabus.org](http://www.pcoabus.org) for more information regarding the PCAOB's deliberation on CAMs.

The IAASB, which covers audit firms reporting based upon IFRS came to the same conclusion earlier than the PCAOB and requires the reporting of Key Audit Matters (KAMs). See Appendix H for more information about KAMs.

KAMS are also allowed for private companies following AICPA standards. This is known as SAS 134. See Appendix L. This is a little confusing, but here is a simple summary:

- Critical Audit Matters (CAMs) are required for public companies regulated by the PCAOB
- Key Audit Matters (KAMs) are required for non-US stock exchange companies and US stock exchange companies reporting under IFRS
- Key Audit Matters (KAMs) are allowed to be reported under AICPA standards when the client engages the auditor to do so

# Whose CAMs Are They?

As for who the CAMs “belong” to, they are the responsibility of the auditor. The auditor determines what the CAMs are, the number of CAMs, why the CAM is important (critical) and the explanation of each CAM. The auditor also describes how the CAM was addressed in the audit in terms of auditing procedures, etc. Public companies are really only involved when auditors discuss the CAMs with the company’s board of directors and management.

Critical Audit Matters (CAMs) are required by PCAOB standard AS 3101: *The Auditors’ Report on an Audit of Financial Statement When the Auditor Expresses an Unqualified Opinion*. This standard requires the following per the PCAOB:

## *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.

#### *Communication of Critical Audit Matters*

.13 The auditor must communicate in the auditor's report critical audit matters<sup>21</sup> relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period's financial statements are presented on a comparative basis with those of one or more prior periods, the auditor may communicate critical audit matters relating to a prior period. This may be appropriate, for example, when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

.14 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.

Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

Note 2: When describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

#### *Language Preceding Critical Audit Matters in the Auditor's Report*

.15 The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

##### Critical Audit Matters

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.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

.16 In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

#### Critical Audit Matters

Critical audit matters 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. We determined that there are no critical audit matters.

#### *Documentation of Critical Audit Matters*

.17 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;

the auditor must document whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.<sup>22</sup>

## CAM Reporting Effective Date

From the PCAOB;

***“For audits of fiscal years ending on or after Dec. 15, 2017, except for the requirements related to critical audit matters. The requirements related to critical audit matters in paragraphs .11–.17 will be effective for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020, for all other companies to which the requirements apply, as described in paragraph .05.”***

This means that large companies with a June 30 year end are the first reporters of CAMs. Then, large companies with a December 31 year end follow. See Page 15 for a summary of initial CAM reporting results and Appendix A for Microsoft’s June 30 Auditor’s Report on CAMs.

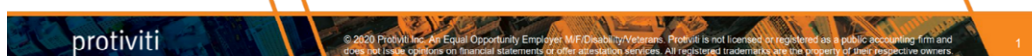
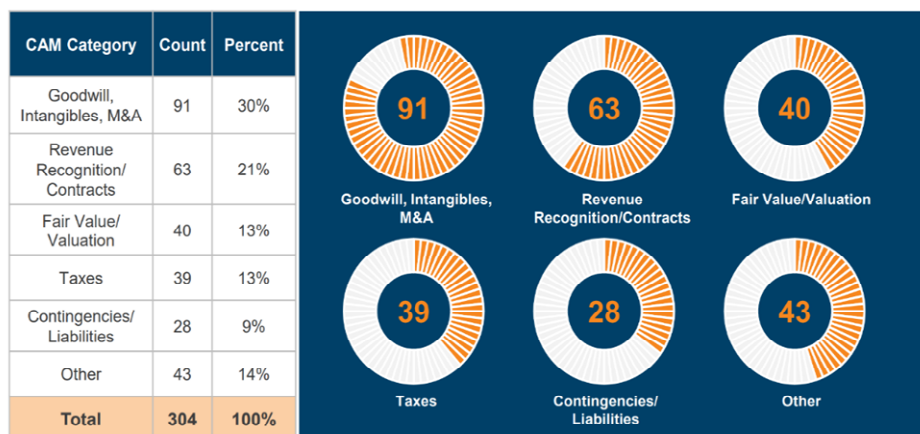
Key Audit Matters (KAMs) promulgated by the IAASB were required to be reported by auditors for audits of financial statements of listed companies for periods ending on or after December 15, 2016. See Appendix H for an article describing the two standards.

## Early CAM Reporting and Most Common CAMs

One of the first companies to report CAMs was Microsoft Corporation because it's fiscal year end is June 30. See Appendix A for the Microsoft audit report for both 2018 and 2019 where CAMs were reported for the first time in 2019. One of the last companies to report CAM's will be Oracle Corporation, whose fiscal year end is May 30. It will be interesting to see how similar or different the two company's CAM's are, once Oracle's CAM's are reported by EY.

Since the vast majority of public companies have December year ends, there is limited information on CAM's at this time. That being said, based on all of the early CAM reporting being done, there are some matters that are more likely to be CAM's than others. That information is provided below, with a graphic done by Protiviti on CAM reporting in 2019:

### CRITICAL AUDIT MATTERS AS OF DECEMBER 2019



Based on the information being presented above, goodwill, intangibles and revenue recognition tend to be the most common CAM's. This does make some sense, considering these accounts and related audit considerations can be subjective and require a thorough analysis to make sure they are accurate.



In my research, I found an interesting CAM related to mergers and acquisitions for a company called Westrock, which has a year end of September 30. EY are the auditors for this company. That CAM was worded as follows:

#### **Critical Audit Matters**

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 139 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 consolidated 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.

#### ***Accounting for the Acquisition of KapStone Paper and Packaging Corporation***

##### *Description of the Matter*

During 2019, the Company completed its acquisition of KapStone Paper and Packaging Corporation (KapStone) for net consideration of \$4.9 billion including debt assumed (the "Transaction"), as disclosed in Note 3 to the consolidated financial statements. The Transaction is accounted for as a business combination and the Company preliminarily allocated \$1,303.0 million of the purchase price to the fair value of the acquired customer relationship intangible assets. The Company is in the process of analyzing the estimated values of all assets acquired and liabilities assumed including, among other things, finalizing third-party valuations of certain tangible and intangible assets, as well as the fair value of certain contracts and the determination of certain tax balances; therefore, the allocation of the purchase price is preliminary and subject to revision as of September 30, 2019. Auditing management's preliminary allocation of purchase price for its acquisition of KapStone involved especially subjective and complex judgements due to the significant estimation required in determining the fair value of customer relationship intangible assets. The significant estimation was primarily due to the complexity of the valuation models used to measure that fair value as well as the sensitivity of the respective fair values to the underlying significant assumptions. The significant assumptions used to estimate the fair value of the customer relationship intangible assets and subsequent amortization expense included discount rates, customer attrition rates and economic lives. These significant assumptions are forward looking and could be affected by future economic and market conditions.

##### *How We Addressed the Matter in Our Audit*

We tested the design and operating effectiveness of the Company's controls related to the accounting for the KapStone acquisition. For example, we tested controls over the recognition and measurement of customer relationship intangible assets in the acquisition, including the Company's controls over the valuation model, the mathematical accuracy of the valuation model and development of underlying assumptions used to develop such fair value measurement estimates. To test the fair value of the Company's customer relationship intangible assets, our audit procedures included, among others, evaluating the Company's valuation model, the method and significant assumptions used and testing the completeness and accuracy of the underlying data supporting the significant assumptions and estimates. We involved our valuation specialists to assist with our evaluation of the valuation model and certain significant assumptions. For example, we reconciled the discount rates to the projected internal rate of return for the Transaction and compared the attrition rates to industry data. In addition, to evaluate the effect of changes in assumptions, we performed sensitivity analysis of the fair value of customer relationship intangible assets, and of amortization expense to the economic lives assigned to the customer relationship intangible assets.

## The Math of CAMs

I thought it would be interesting to do a little “math” related to CAMs as follows:

- 1) Number of CAM’s estimated to be created in the 2019 corporate reporting season.
  - a. There are approximately 4,000 US stock exchange companies
  - b. There is an average of 1.7 \* CAM’s per company
  - c. Based on that information, 6,800 CAM’s would be created.
  
- 2) The Critical Audit Matters section of Microsoft’s 2019 Audit Report was 874 words. Extrapolating this to 4,000 companies, will result in a total of 3,496,000 words being added to the Audit Reports of all public companies.

\*per Audit Analytics study as of December 17<sup>th</sup>. Showed 333 CAM’s for 193 large accelerated filers.

## The Cost of CAMs

The cost of reporting CAM's will not be free. Audit Firms will spend time determining what CAM's should be reported. They will also discuss CAM's internally, with the company and its audit committee as well as documenting their decisions about CAM's.

In addition, a company will spend time discussing the CAM's that will be reported by their auditor.

In making an estimate of the costs of CAM reporting, I've made the following assumptions:

- 1) Average audit firm billing rate per hour of \$200
- 2) Hours spent per CAM of 50, 100 and 200 hours per CAM

If there are 6,800 CAM's being reported then the costs billed to companies would be:

- @50 hours: \$ 68,000,000
- @100 hours: \$136,000,000
- @200 hours: \$272,000,000

You could also make the following assumption about a company's internal costs to address CAM's, at \$10,000, \$20,000 and \$50,000 per CAM. Again, assuming 4,000 public companies and 1.7\* CAM's per company. This adds up to:

- @\$10,000: \$ 68,000,000
- @\$20,000: \$136,000,000
- @\$50,000: \$340,000,000

Therefore, my estimate for the total cost of CAM's (external and internal costs) would range from \$136 million to \$612 million. Assuming 4,000 companies this equates from \$34,000 to \$153,000 per company.

\*per Audit Analytics study as of December 17<sup>th</sup>. Showed 333 CAM's for 193 large accelerated filers.

**So, the question becomes, is all of this worth it? Will users find value in this expanded reporting and will it help auditors and companies?**

## CAMs vs. KAMs

As mentioned earlier, they are either Key Audit Matters (KAMs) or Critical Audit Matters (CAMs). US stock exchange companies will primarily report CAMs while companies on other stock exchanges using IFRS will report KAMs. This is similar to the discussion in my August 2019 report on ASC 842, which is a US GAAP standard. A similar leasing standard, IFRS 16, exists for companies reporting on IFRS.

To compare the difference between the two, look at Microsoft's 2019 auditor's report (Appendix A) and BP's 2018 auditor's report (Appendix G)

Source: CPA Journal

### Defining a CAM/KAM

*The definition of a CAM/KAM leaves what auditors may consider to be critical or key largely to judgment. Under AS 3101, CAMs are matters arising from the audit of the financial statements that have been communicated or were required to be communicated to the audit committee, are "related to" auditing accounts or disclosures that are material to the financial statements, and involve especially challenging, subjective, or complex auditor judgment. The final standard was modified to limit it to matters that are material to the financial statements, in response to concerns that auditors might otherwise be required to communicate information that management is not required to disclose. Some commenters stated that communicating immaterial matters would lead management to revise its disclosures to include a discussion of any matter identified as critical, regardless of materiality, or weaken and obscure the auditor's opinion because such matters would be irrelevant to investors and other financial statement users. "Related to" clarifies that a CAM could be an element or aspect of an account or disclosure in the financial statements and does not necessarily need to correspond to the entire account or disclosure. For example, the auditor's evaluation of the company's goodwill impairment assessment could be a CAM; it would relate to goodwill because impairment is an aspect of that account. In addition, a CAM does not need to relate to a single account or disclosure, but could relate to several, or have a pervasive effect on the financial statements as a whole. Thus, the auditor's evaluation of the company's ability to continue as a going concern would be a CAM.*

*Conversely, a matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a CAM. For example, a potential loss contingency that was communicated to the audit committee but determined to be remote and not disclosed in the*

*financial statements, a potential illegal act for which no disclosure was required, or the determination that there is a significant deficiency in internal control over financial reporting could not be a CAM.*

*The IAASB adopted a more principles-based approach to the definition of a KAM than the PCAOB did in defining a CAM, although the frameworks for determining a CAM/KAM are substantially similar and begin with those matters communicated or required to be communicated to the audit committee. Under ISA 701, KAMs are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Although materiality is not included in the definition of a KAM, paragraph A29 of ISA 701 notes that the importance of the matter to the intended users' understanding of the financial statements as a whole, and in particular its materiality to the financial statements, may be relevant to determining the relative significance of a matter communicated with those charged with governance, and therefore whether such a matter is a KAM.*

## Conclusion – The Future of CAMs

This being my third independent study report, all of them (SASB, Leasing and CAM's) have covered new and emerging topics. Like those reports, only time will tell if CAMs will catch on and are valued by investors in the future.

Some questions to consider about CAMs include:

*Will the wording of CAMS continue to evolve and how?*

*Will the number of CAMs per company increase, decrease or stay the same?*

*What kind of new CAMS will emerge?*

*How many audit reports will there be with no CAMs?*

*How will users benefit from this reporting?*

*Will the PCAOB disagree with CAMS reported by auditors?*

*Will litigation against companies and auditors be aided or hurt by CAM reporting?*

*How standardized might CAM wording become?*

*How will CAM wording vary by accounting firm?*

*Will CAM reporting take hold for non-public companies?*

*Will new accounting standards create new CAMs?\**

*How will CAMS and KAMS continue to differ or be the same?*

(I was aided by a CPA in connection with the questions above)

# Appendix A: The First CAMs

One of the first auditors reports to include critical audit matters was Deloitte's report for Microsoft Corporation in August of 2019 as Microsoft has a June 30 year end. Deloitte are the auditors.

## 2018 Report- No CAMs:

### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of Microsoft Corporation

#### Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2018 and 2017, the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended June 30, 2018, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2018, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of June 30, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 3, 2018, expressed an unqualified opinion on the Company's internal control over financial reporting.

#### Change in Accounting Principles

As discussed in Note 1 to the financial statements, the Company has changed its method of accounting for revenue from contracts with customers and for accounting for leases in fiscal year 2018 due to the adoption of the new revenue standard and new lease standard, respectively. The Company adopted the new revenue standard using the full retrospective approach and adopted the new lease standard using a modified retrospective approach.

#### Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ DELOITTE & TOUCHE LLP  
Seattle, Washington  
August 3, 2018

We have served as the Company's auditor since 1983.



## **2019 Report- CAMs reported for the first time**

### **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Stockholders and the Board of Directors of Microsoft Corporation

#### **Opinion on the Financial Statements**

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2019 and 2018, the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended June 30, 2019, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2019, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of June 30, 2019, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 1, 2019, expressed an unqualified opinion on the Company's internal control over financial reporting.

#### **Basis for Opinion**

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

#### **Critical Audit Matters**

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 Company's 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.

## Revenue Recognition — Refer to Note 1 to the Financial Statements

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### Critical Audit Matter Description

The Company recognizes revenue upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. The Company offers customers the ability to acquire multiple licenses of software products and services, including cloud-based services, in its customer agreements through its volume licensing programs.

Significant judgment is exercised by the Company in determining revenue recognition for these customer agreements, and includes the following:

- Determination of whether products and services are considered distinct performance obligations that should be accounted for separately versus together, such as software licenses and related services that are sold with cloud-based services.
- Determination of stand-alone selling prices for each distinct performance obligation and for products and services that are not sold separately.
- The pattern of delivery (i.e., timing of when revenue is recognized) for each distinct performance obligation.
- Estimation of variable consideration when determining the amount of revenue to recognize (e.g., customer credits, incentives, and in certain instances, estimation of customer usage of products and services).

Given these factors, the related audit effort in evaluating management's judgments in determining revenue recognition for these customer agreements was extensive and required a high degree of auditor judgment.

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### How the Critical Audit Matter Was Addressed in the Audit

Our principal audit procedures related to the Company's revenue recognition for these customer agreements included the following:

- We tested the effectiveness of internal controls related to the identification of distinct performance obligations, the determination of the timing of revenue recognition, and the estimation of variable consideration.
- We evaluated management's significant accounting policies related to these customer agreements for reasonableness.
- We selected a sample of customer agreements and performed the following procedures:
  - Obtained and read contract source documents for each selection, including master agreements, and other documents that were part of the agreement.
  - Tested management's identification of significant terms for completeness, including the identification of distinct performance obligations and variable consideration.
  - Assessed the terms in the customer agreement and evaluated the appropriateness of management's application of their accounting policies, along with their use of estimates, in the determination of revenue recognition conclusions.
- We evaluated the reasonableness of management's estimate of stand-alone selling prices for products and services that are not sold separately.
- We tested the mathematical accuracy of management's calculations of revenue and the associated timing of revenue recognized in the financial statements.

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**Income Taxes — Uncertain Tax Positions — Refer to Note 12 to the Financial Statements**

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**Critical Audit Matter Description**

The Company's long-term income taxes liability includes uncertain tax positions related to transfer pricing issues that remain unresolved with the Internal Revenue Service ("IRS"). The Company remains under IRS audit, or subject to IRS audit, for tax years subsequent to 2003. While the Company has settled a portion of the IRS audits, resolution of the remaining matters could have a material impact on the Company's financial statements.

Conclusions on recognizing and measuring uncertain tax positions involve significant estimates and management judgment and include complex considerations of the Internal Revenue Code, related regulations, tax case laws, and prior-year audit settlements. Given the complexity and the subjective nature of the transfer pricing issues that remain unresolved with the IRS, evaluating management's estimates relating to their determination of uncertain tax positions required extensive audit effort and a high degree of auditor judgment, including involvement of our tax specialists.

**How the Critical Audit Matter Was Addressed in the Audit**

Our principal audit procedures to evaluate management's estimates of uncertain tax positions related to unresolved transfer pricing issues included the following:

- We evaluated the appropriateness and consistency of management's methods and assumptions used in the identification, recognition, measurement, and disclosure of uncertain tax positions, which included testing the effectiveness of the related internal controls.
- We read and evaluated management's documentation, including relevant accounting policies and information obtained by management from outside tax specialists, that detailed the basis of the uncertain tax positions.
- We tested the reasonableness of management's judgments regarding the future resolution of the uncertain tax positions, including an evaluation of the technical merits of the uncertain tax positions.
- For those uncertain tax positions that had not been effectively settled, we evaluated whether management had appropriately considered new information that could significantly change the recognition, measurement or disclosure of the uncertain tax positions.
- We evaluated the reasonableness of management's estimates by considering how tax law, including statutes, regulations and case law, impacted management's judgments.

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/s/ DELOITTE & TOUCHE LLP  
Seattle, Washington  
August 1, 2019

We have served as the Company's auditor since 1983.

# Appendix B: pwc and CAMs

point of  
*view*

December 2017

## *Auditor reporting* Changes coming

**pwc**

### Insights from the auditor

- The PCAOB's new auditor reporting standard sets forth the most significant changes to the auditor's report in over 70 years. While the pass/fail opinion has been retained, certain changes have been made to the form and content of the auditor's report, including a requirement to share critical audit matters (CAMs).
- CAMs are matters arising from the audit that involved especially challenging, subjective or complex auditor judgment, that relate to material accounts or disclosures in the financial statements, and that were discussed with the audit committee. Auditors will be required to disclose CAMs in the audit report and describe how they addressed them during the audit.
- The PCAOB believes that the inclusion of CAMs in the auditor's report can enhance the report's informational value by providing stakeholders with perspectives on the financial statements through a deeper understanding of the audit. Providing visibility to areas that involved significant judgment by the auditor is responsive to calls from users to make the auditor's report more informative – but brings challenges that must be considered.
- Implementing this standard will likely be a significant undertaking. Management and audit committees should engage in a dialogue with auditors to understand the types of matters that may be CAMs based on their company's facts and circumstances. Management and audit committees may want to focus on disclosures in these areas in advance of the new auditor reporting.

# Appendix C: KPMG and CAMs

## Critical audit matters

Critical Audit Matters (CAMs) are those matters arising from the financial statement audit 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. involve especially challenging, subjective or complex auditor judgment.

The requirement to communicate CAMs is intended to provide more information about the audit and make the auditors' report more informative and relevant to investors and other financial statement users.

This communication is based on information known to the auditor and procedures already performed as part of the audit. However, the new standard imposes incremental audit performance requirements about determining the CAMs, communicating with the audit committee, documenting key elements in the auditors work papers and drafting Critical Audit Matters within the auditors' report. In the unusual situation in which the auditor determines that there were no Critical Audit Matters, the auditor must state that fact. The Critical Audit Matters section of the auditors' report will follow the Basis for Opinion section.

## When will CAMs go into effect?

- The requirement to communicate Critical Audit Matters in the auditors' report is effective for audits of large accelerated filers for years ending on or after **June 30, 2019**.
- For all other filers for which the CAM requirements are applicable, it is effective for fiscal years ending on or after **December 15, 2020**.

## What matters might be identified as especially challenging, subjective or complex auditor judgment?

The standard describes the following factors that the auditor should take into account, alone or in combination, as well as other factors specific to the audit, when determining whether a matter involved is especially challenging, subjective or a complex auditor judgment:

- 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 these 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.

# Appendix D: EY and CAMs

## Key differences between auditing standards adopted by the AASB and the PCAOB

On 1 June 2017, the PCAOB adopted a new auditor reporting standard: *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion*. This new auditing standard is subject to approval by the U.S. Securities and Exchange Commission (SEC).

The standard requires auditors to add information about auditor tenure, clarify the language about the auditor's responsibilities, and change the organization and format of the auditor's report. Those requirements are effective for annual periods ending on or after 15 December 2017. In 2015, the PCAOB approved a standard that requires the disclosure of the audit engagement partner and certain other participants in the audit in a new form (Form AP). The disclosure of the engagement partner is required for reports issued on or after 31 January 2017, while the disclosure of other participants is required in reports issued on or after 30 June 2017.

The standard also requires auditors to include in the auditor's report information about matters that they communicated or were required to communicate to the audit committee that relate to material accounts or disclosures and involved especially challenging, subjective or complex auditor judgment. These are known as critical audit matters (CAM). The framework for determining CAM is substantially similar to the framework for determining KAM and starts with those matters communicated or required to be communicated to the audit committee.

CAM reporting requirements are effective for annual periods ending on or after 30 June 2019 for large accelerated filers and on or after 15 December 2020 for all other filers (with certain exceptions, such as securities brokers and dealers that are not issuers, certain investment companies, employee stock purchase, savings and similar plans, and emerging growth companies).

### The key differences between the AASB reporting standards and the PCAOB standards are:

- ▶ The PCAOB standard will require all entities that conduct their audits under PCAOB standards to report CAM in their auditor's report, whereas KAM are optional under the final AASB standard unless required by law or regulation.
- ▶ Except for the CAM reporting requirement, the PCAOB standard is effective for entities for periods ending on or after 15 December 2017 and the AASB reporting standard is effective on or after 15 December 2018.
- ▶ The PCAOB standard requires the auditor's report to disclose the tenure of the audit firm, which is not a requirement under the AASB reporting standard.
- ▶ The AASB standard requires the auditor's report to disclose the name of the audit engagement partner for audits of listed entities, whereas the PCAOB requires audit firms to file a Form AP with the PCAOB that names the audit engagement partner (i.e., the partner with primary responsibility for the audit) and discloses information about certain accounting firms that participated in the audit. The form is available to the public on the PCAOB website.

## What's next?

Significant efforts will be required to implement the enhanced auditor's reporting standards. Management, TCWG, and the auditors should align their goal of improving communications so as to ensure smooth implementation in 2018 calendar-year audits. For those entities that are subject to the PCAOB standard or ISA, the auditors, management, and TCWG should consider the unique requirements that are in effect for their upcoming audits.

The AASB is considering the final PCAOB standard and monitoring SEC approval status. Given the AASB objective of adopting the ISA, we expect that the AASB will take some action following SEC approval of the PCAOB standard, expected in fall 2017. We expect that this will entail the auditors of some population of larger Canadian listed entities being required to apply KAM reporting on a similar timeline as the CAM reporting requirement under the PCAOB standards.

The AASB has indicated that it will continue to study the issue of the applicability and timing of KAM reporting applying to the smallest listed entities. The AASB has communicated that it will take additional time to further assess this.

At the same time, there is a task force working on how the current and future Canadian auditor's report can be harmonized with the new US auditor's report to allow companies to continue to issue a single auditor's report meeting Canadian and US standards.

While this process has not been concluded, companies that have issued a report under Canadian and US standards in the past should plan to continue to do so as the working group works to bring this process to conclusion.

The AASB is working directly with the Australian standard setter to study their experience in implementing the new auditor reporting standards, particularly with respect to smaller listed entities. They will review experience gained in Canada by those who apply KAM reporting in accordance with law or regulation, as well as those who apply this reporting voluntarily. The IAASB is also scheduled to conduct a post-implementation review on auditor reporting.

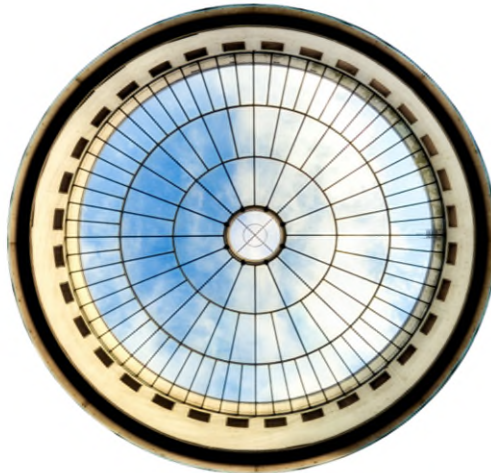
Insights gained from these activities will guide the AASB in future deliberations on this additional level of transparency in the auditor's report.

# Appendix E: Deloitte and CAMs



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## In This Issue

- [Introduction](#)
- [CAM Results for Large Accelerated Filers With Fiscal Years Ending June 30, 2019](#)
- [CAM Dry Runs](#)
- [Looking Ahead](#)
- [Appendix — Resources](#)

## Critical Audit Matters Make Their Debut!

by Lisa Smith and Kerry Fulchino, Deloitte & Touche LLP

### Introduction

The first auditors' reports with critical audit matters (CAMs) were filed! In auditors' reports for all large accelerated filers with fiscal years ending June 30, 2019, the CAMs most often identified were related to goodwill and intangible assets, revenue, and income taxes, and on average, 1.8 CAMs were communicated.

In 2017, the PCAOB and SEC approved [PCAOB Auditing Standard 3101](#) (the "standard"),<sup>1</sup> which substantially revised the auditor's reporting model. The most significant change was the requirement for auditors to include CAMs<sup>2</sup> in the auditor's report. The standard is effective for audits of large accelerated filers for fiscal years ending on or after June 30, 2019, and will become effective for audits of all other companies that are subject to the requirements<sup>3</sup> for fiscal years ending on or after December 15, 2020.

The more commonly identified CAMs are related to accounts or disclosures in which there is a high degree of auditor subjectivity associated with applying audit procedures and evaluating the results of those procedures. However, a CAM could also be identified for an account or disclosure that is especially challenging or complex to audit.

<sup>1</sup> PCAOB Auditing Standard No. 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For more information about the standard, see Deloitte's June 20, 2017, [Heads Up](#).

<sup>2</sup> As defined in the standard, a CAM 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."

<sup>3</sup> The standard specifies that communication of CAMs "is not required for audits of (1) brokers and dealers reporting under [Rule 17a-5 of the Securities Exchange Act of 1934 (the "Exchange Act")]; (2) investment companies registered under the Investment Company Act of 1940 . . . other than . . . business development companies; (3) employee stock purchase, savings, and similar plans; and (4) emerging growth companies [as defined in Section 3(a)(80) of the Exchange Act]" (footnotes omitted).

## Appendix F: The Center for Audit Quality on CAMs

During my research, I found some excellent material issued by the *Center For Audit Quality* (CAQ) on CAMs. Because the document is 12 pages long, I have provided a link to it below. The document covered:

- Lessons learned from early Dry Runs
- Questions to consider for audit committees
- Illustrative examples

[https://www.thecaq.org/wp-content/uploads/2019/03/caq\\_critical\\_audit\\_matters\\_lessons\\_questions\\_example\\_2018-12.pdf](https://www.thecaq.org/wp-content/uploads/2019/03/caq_critical_audit_matters_lessons_questions_example_2018-12.pdf)



# Appendix G: BP and KAMs

Here are BP’s KAMs described in the 2018 auditor’s report:

## Consolidated financial statements of the BP group

### Independent auditor’s report on the Annual Report and Accounts to the members of BP p.l.c.

#### Report on the audit of the financial statements

##### Opinion

In our opinion:

- The financial statements of BP p.l.c. (the ‘parent company’) and its subsidiaries (the ‘group’) give a true and fair view of the state of the group’s and of the parent company’s affairs as at 31 December 2018 and of the group’s profit for the year then ended.
- The group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU) and IFRSs as issued by the International Accounting Standards Board (IASB).
- The parent company financial statements have been properly prepared in accordance with United Kingdom generally accepted accounting practice including FRS 101 ‘Reduced Disclosure Framework’.
- The financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements of BP p.l.c. which comprise:

- Group income statement;
- Group statement of comprehensive income;
- Group and parent company statements of changes in equity;
- Group and parent company balance sheets;
- Group cash flow statement;
- Group related Notes 1 to 38 to the financial statements, including a summary of significant policies; and
- Parent company related Notes 1 to 14 to the financial statements, including a summary of significant accounting policies.

The financial reporting framework that has been applied in the preparation of the group financial statements is applicable law and IFRSs as adopted by the European Union and as issued by the IASB. The financial framework that has been applied in the preparation of the parent company financial statements is applicable law and United Kingdom accounting standards including FRS 101 (United Kingdom generally accepted accounting practice).

##### Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor’s responsibilities for the audit of the financial statements section of our report.

We are independent of the group and the parent company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council’s (the ‘FRC’s’) Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC’s Ethical Standard were not provided to the group or the parent company.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

##### Summary of our audit approach

<b>Key audit matters</b>	<p>The key audit matters that we identified in the current year were:</p> <ul style="list-style-type: none"> <li>• Impairment of Upstream oil and gas property, plant and equipment (PP&amp;E) assets;</li> <li>• Accounting for acquisitions and disposals within the Upstream segment;</li> <li>• Impairment of exploration and appraisal assets;</li> <li>• Accounting for structured commodity transactions within the integrated supply and trading function, and the valuation of other level 3 financial instruments, where fraud risks may arise in revenue recognition;</li> <li>• User access management controls relating to financial systems; and</li> <li>• Management override of controls.</li> </ul> <p>Two key audit matters were identified by the previous auditor and described in their report for the year ended 31 December 2017 and are not included in our report for the year ended 31 December 2018. These were:</p> <ul style="list-style-type: none"> <li>• The determination of the liabilities, contingent liabilities and disclosures arising from the Gulf of Mexico oil spill- the provisions have substantially decreased from a quantitative perspective and the level of judgement in determining BP’s liabilities has reduced significantly as legal settlements have been reached; and</li> <li>• US Tax reform - the reform was signed into law in 2017 and gave rise to a one-off taxation charge. Whilst the impact of the reform has continued to be assessed in 2018, the judgement required and quantitative impact in the current year is considerably lower.</li> </ul> <p>The previous auditor also included a key audit matter in respect of unauthorized trading activity in the integrated supply and trading function. This is covered by the key audit matter set out above covering the accounting for structured commodity transactions and valuation of certain level 3 financial instruments. They also identified a key audit matter in respect of the estimation of oil and gas reserves and resources, which we have considered in the context of impairment of Upstream oil and gas PP&amp;E assets.</p>
<b>Materiality</b>	<p>We have set materiality for the current year at \$750 million based on profit before tax and underlying replacement cost profit before interest and tax.</p>

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<b>Scoping</b>	Our scope covered 136 components. Of these, 108 were full-scope audits, covering 71% of group revenue, and the remaining 28 were subject to specific procedures on certain account balances by component audit teams or the group audit team.
<b>First year audit transition</b>	<p>The year ended 31 December 2018 is our first as auditor of the group. We commenced transition activities after our selection as auditor being announced in November 2016.</p> <p>These activities included:</p> <ul style="list-style-type: none"> <li>• Establishing independence from BP by exiting non-audit services which would be independence-impairing, as BP transitioned these to new service providers;</li> <li>• Establishing an appropriately resourced and skilled global audit team, including specialists, in all relevant locations;</li> <li>• Developing and delivering a bespoke “BP Academy” training course for Deloitte personnel joining the BP audit engagement; and</li> <li>• Holding introductory meetings with BP management.</li> </ul> <p>We commenced our audit planning procedures subsequent to us becoming independent on 16 October 2017. After establishing independence, our work included:</p> <ul style="list-style-type: none"> <li>• Shadowing the previous auditor through the 31 December 2017 audit, including attendance at key meetings, including audit committee meetings;</li> <li>• Reviewing the previous auditor’s 2016 and 2017 audit files;</li> <li>• Reviewing historical accounting policies and accounting judgements through discussion with management and review and challenge of management’s papers and supporting documentation; and</li> <li>• Conducting group audit team visits to components.</li> </ul> <p>These procedures built our understanding of the group which, together with our existing knowledge of the oil and gas industry, informed our audit risk assessment, through which we identified the risks of material misstatement to the group’s financial statements.</p> <p>We presented our transition observations to the group’s audit committee in a transition report in April 2018, with an update in May 2018. We presented further observations, together with our audit plan, in July 2018, and provided an update to our plan in December 2018.</p>

**Conclusions relating to going concern, principal risks and viability statement**

**Going concern**

We have reviewed the directors’ statement on page 111 about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the group’s and company’s ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

We considered as part of our risk assessment the nature of the group, its business model and related risks including where relevant the impact of Brexit, the requirements of the applicable financial reporting framework and the system of internal control. We evaluated the directors’ assessment of the group’s ability to continue as a going concern, including challenging the underlying data and key assumptions used to make the assessment, and evaluated the directors’ plans for future actions in relation to their going concern assessment.

We are required to state whether we have anything material to add or draw attention to in relation to that statement required by Listing Rule 9.8.6R(3) and report if the statement is materially inconsistent with our knowledge obtained in the audit.

**We confirm that we have nothing material to report, add or draw attention to in respect of these matters.**

**Principal risks and viability statement**

Based solely on reading the directors’ statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the directors’ assessment of the group’s and the company’s ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on pages 55-56 that describe the principal risks and explain how they are being managed or mitigated;
- the directors’ confirmation on page 110 that they have carried out a robust assessment of the principal risks facing the group, including those that would threaten its business model, future performance, solvency or liquidity; or
- the directors’ explanation on page 111 as to how they have assessed the prospects of the group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We are also required to report whether the directors’ statement relating to the prospects of the group required by Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit.

**We confirm that we have nothing material to report, add or draw attention to in respect of these matters.**

**Key audit matters**

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified.

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These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

Throughout the course of our audit we identify risks of material misstatement ('risks') and classify those risks according to their severity. In assigning a category we consider both the likelihood of a risk of a material misstatement and the potential magnitude of a misstatement in making the assessment. Certain risks are classified as 'significant' or 'higher' depending on their severity. The category of the risk determines the level of evidence we seek in providing assurance that the associated financial statement item is not materially misstated.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

<b>Impairment of upstream oil and gas PP&amp;E assets</b>	
<b>Key audit matter description</b>	<b>How the scope of our audit responded to the key audit matter</b>
<p>The group balance sheet includes property, plant and equipment (PP&amp;E) of \$135 billion, of which \$99 billion is oil and gas properties within the Upstream segment. As required by IAS 36 'Impairment of Assets', management performed a review of the upstream cash generating units (CGUs) for indicators of impairment and impairment reversal as at 31 December 2018.</p> <p>Where such indicators were identified, management estimated the recoverable amount of the CGU to determine if any impairment charges or reversals were required. For the year ended 31 December 2018, BP recorded \$400 million of Upstream impairment charges and \$580 million of impairment reversals.</p> <p>Through our risk assessment procedures, we have determined that there are three key estimates in management's review for indicators of impairment/reversal and the level of impairment charge/reversal to record where indicators are identified. These are:</p> <ul style="list-style-type: none"> <li>• <b>Long-term oil and gas prices</b> - BP's long-term oil and gas price assumptions have a significant impact on CGU impairment assessments and valuations performed across the portfolio, and are inherently uncertain. There is a risk that management's oil and gas price assumptions are not reasonable, leading to a material misstatement.</li> <li>• <b>Discount rates</b> - Given the long timeframes involved, certain impairment assessments and valuations are sensitive to the discount rate applied. There is a risk that discount rates do not reflect the return required by the market and the risks inherent in the cash flows being discounted, leading to a material misstatement. Determination of the appropriate discount rate can be judgemental.</li> <li>• <b>Reserves estimates</b> - A key input to impairment assessments and valuations is the production forecast, in turn closely related to the group's reserves estimates and field development assumptions. CGU-specific estimates are not generally material. However, material misstatements could arise either from systematic flaws in reserves estimation policies, or due to flawed estimates in a particularly material individual impairment test.</li> </ul> <p>Whilst all CGUs must be assessed for indicators of impairment and impairment reversal annually, we focused on certain individual CGUs with a total carrying value of \$21.8 billion which we determined would be most at risk of a material impairment (\$750 million) as a result of a reasonably possible change in the key assumptions, particularly the long-term oil and gas price assumptions. Accordingly, we identified these as a significant audit risk. We also focused on assets with a further \$31.5 billion of combined CGU carrying value which were less sensitive. We identified these as a higher audit risk as they would be potentially at risk in aggregate to a material impairment by a change in such assumptions. Further information regarding these sensitivities is given in Note 1.</p>	<p>We tested management's internal controls over the setting of oil and gas prices, discount rates and reserve estimates. In addition, we conducted the following substantive procedures.</p> <p><b>Long-term oil and gas prices</b></p> <ul style="list-style-type: none"> <li>• We compared BP's oil and gas price assumptions against third-party forecasts, peer information and relevant market data to determine whether BP's forecasts were within the range of such forecasts.</li> <li>• In challenging management's forecasts, we considered the extent to which they reflected the energy transition due to climate change.</li> </ul> <p><b>Discount rates</b></p> <ul style="list-style-type: none"> <li>• We independently evaluated BP's discount rates used in impairment tests with input from Deloitte valuation specialists.</li> <li>• We assessed whether country risks were appropriately reflected in BP's discount rates.</li> </ul> <p><b>Reserves estimates</b></p> <ul style="list-style-type: none"> <li>• We performed a look-back analysis to check for indications of bias over time.</li> <li>• We reviewed BP's reserves estimation methods and policies, assisted by Deloitte reserves experts.</li> <li>• We assessed how these policies had been applied to seven internal reserves estimates.</li> <li>• We reviewed reports provided by external experts and assessed their scope of work and findings.</li> <li>• We assessed the competence, capability and objectivity of BP's internal and external reserve experts, through obtaining their relevant professional qualifications and experience.</li> </ul> <p><b>Other procedures</b></p> <ul style="list-style-type: none"> <li>• We challenged management's cash generating unit determination, scrutinized the impairment and impairment reversal indicator analysis and considered whether there was any contradictory evidence present.</li> <li>• Where such indicators were identified, we validated that BP's asset impairment methodology was appropriate and tested the integrity of impairment models.</li> <li>• We compared hydrocarbon production forecasts and proved and probable reserves to reserve reports and our understanding of the life of fields.</li> <li>• We verified estimated future capital and operational costs by comparison to approved budgets and assessed them with reference to field production forecasts.</li> <li>• We also assessed these estimates against management's historical forecasting accuracy and whether the estimates had been determined and applied on a consistent basis across the group where relevant.</li> </ul>

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<b>Key observations</b>	<p><b>Long-term oil and gas prices</b> We determined that BP's Brent oil price forecasts are reasonable when compared against the range of other third-party forecasts.</p> <p>We challenged BP's Henry Hub, NBP and Asian LNG price curves for periods when they were somewhat higher than the range of other third-party forecasts. However, management ran additional tests using a Henry Hub, NBP and Asian LNG price curve consistent with the range of third-party forecasts, which demonstrated that the carrying values recorded in the balance sheet are not impacted.</p> <p><b>Discount rates</b> Our Deloitte valuation specialists calculated a different range for weighted average cost of capital than was determined by management. We also found that some simplifications are taken when making group-wide assumptions for country and asset-specific risk premium adjustments, and for calculating pre-tax discount rates, given the group's CGUs which operate in multiple tax jurisdictions.</p> <p>Management reperformed impairment tests using higher discount rates and only one impairment test was impacted, with a difference which was not significant. Accordingly we were satisfied with the results of the testing.</p> <p>We reviewed the disclosures included in Note 1 to the accounts in respect of price and discount rate assumptions used and confirmed that they were the same as those used in the impairment tests.</p> <p><b>Reserves estimates</b> Having involved Deloitte oil and gas reserves experts in our testing, we concluded that the assumptions used to derive the estimates were reasonable.</p>
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<b>Accounting for acquisitions and disposals within the Upstream segment</b>	
<b>Key audit matter description</b>	<b>How the scope of our audit responded to the key audit matter</b>
<p>There were certain acquisition and disposal transactions within the Upstream segment that required fair valuation of assets and liabilities acquired and disposed of, and consideration of complex accounting judgements, to which we devoted significant engagement team time and resource. Accordingly, this had a significant effect on our audit strategy. These transactions were:</p> <ul style="list-style-type: none"> <li>• The \$10.3 billion acquisition of onshore US assets from BHP, including the fair valuation of assets and liabilities acquired;</li> <li>• The disposal of BP's interest in the Greater Kuparuk Area in Alaska and simultaneous purchase of an incremental interest in the BP-operated Clair field in the UK North Sea; and</li> <li>• The disposal of BP's interest in the Magnus field in the North Sea, where the consideration included a level 3 financial asset, the valuation of which depends on the future performance of Magnus.</li> </ul>	<p>We tested management's internal key controls over the valuation assumptions and accounting approaches for each of these significant transactions. In addition, we conducted the following substantive procedures:</p> <ul style="list-style-type: none"> <li>• We reviewed the enacted sale and purchase agreements and management's accounting analysis to corroborate that the accounting treatment applied was consistent with the underlying commercial terms.</li> <li>• With input from our valuations and reserves specialist teams, we reviewed and challenged management's fair value estimates, focusing on the key assumptions (including pricing, discount rates and reserves risking estimates).</li> <li>• We tested the mechanical accuracy of the valuation models.</li> <li>• We assessed the independence, objectivity, competence and scope of work performed by BP's third-party valuation specialist used in the acquisition from BHP.</li> </ul>
<b>Key observations</b>	<p>We noted that the assumptions underlying the fair value calculation for the onshore US assets acquired from BHP were at the conservative end of the range but concurred that the purchase price represented the fair value of the assets and liabilities acquired, in accordance with IFRS 3.</p> <p>We observed that in some cases, the fair values of oil and gas assets from certain market transactions, including the BHP acquisition, implied valuation assumptions that were more conservative than those used in value-in-use impairment calculations. The latter, as defined in IAS 36, represents management's best estimate of the future cash flows of an asset, discounted at a market rate of return, whereas the former, as defined in IFRS 13 'Fair Value Measurement', is determined by the prices at which oil and gas assets are actually changing hands in orderly transactions under prevailing market conditions. We concluded that in their respective IFRS contexts, and in the presence of valid evidence, the use of different assumptions to estimate fair values and value in use was appropriate.</p> <p>We reviewed the disclosures included by management in Note 3 to the accounts and concluded that these are compliant with IFRS 3 requirements.</p>

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<b>Impairment of exploration and appraisal assets</b>	
<b>Key audit matter description</b>	<b>How the scope of our audit responded to the key audit matter</b>
<p>The group capitalizes exploration and appraisal (E&amp;A) expenditure on a project-by-project basis in line with IFRS 6 'Exploration for and Evaluation of Mineral Resources'. At the end of 2018, \$16.0 billion of E&amp;A expenditure was carried in the group balance sheet. E&amp;A activity is inherently risky and a significant proportion of projects fail, requiring the write-off of the related capitalized costs when the relevant criteria in IFRS 6 and BP's accounting policy are met.</p> <p>There is a risk that certain capitalized E&amp;A costs are not written off promptly at the appropriate time, in line with information from, and decisions about E&amp;A activities, and the impairment requirements of IFRS 6.</p> <p>Through our detailed risk assessment, which is based on our analysis of the portfolio of E&amp;A assets held by BP, making reference to BP's own analysis of the same assets, we identified a significant risk in respect of certain specific assets in the Gulf of Mexico with a total carrying value of \$2.3 billion, as certain licences in question have expired and a partner has recently withdrawn from other licences, and three licences elsewhere (\$1.6 billion) which are scheduled to expire or require next phase decisions in 2019. BP is in negotiations to extend all these licences. Further details regarding the significant accounting judgement are given in Note 1 to the accounts.</p>	<p>We obtained an understanding of the group's E&amp;A impairment assessment processes and tested management's controls. In addition, we conducted the following substantive procedures:</p> <p>We reviewed and challenged management's significant IFRS 6 impairment judgements, guided by our risk assessment, having regard to the impairment criteria of IFRS 6 and BP's accounting policy. We verified key facts relevant to significant carrying amounts (e.g. obtaining evidence of future E&amp;A plans and budgets, evidence of active dialogue with partners and regulators including negotiations to renew licences or modify key terms).</p> <p>We performed a licence-by-licence risk assessment of the group's E&amp;A balance through to year end, to identify significant carrying amounts with a significant current period risk of impairment (e.g. new information from exploration activities, or imminent licence expiry).</p> <p>We performed a look-back analysis of impairment charges recorded in the period, and assessed whether impairment charges were timely.</p> <p>We tested the completeness and accuracy of information used in management's E&amp;A impairment assessment, by reviewing and testing key controls over management's register of E&amp;A licences and vouching key aspects of this to underlying support (e.g. licence documentation); holding meetings and discussions with operational and finance management; considering adverse changes in management's reserves and resource estimates associated with E&amp;A assets; reviewing correspondence with regulators and joint arrangement partners; and considering the implications of capital allocation decisions. When considering capital allocation decision making, we considered whether any projects are unlikely to proceed on the grounds that they are not currently consistent with BP's strategy or which would otherwise have a prohibitively high environmental or social impact for the directors to sanction the necessary investment.</p>
<b>Key observations</b>	<p>We concluded that the key assumptions had been appropriately determined, the judgements management had made were appropriately supported, and no additional impairments were identified from the work we performed.</p> <p>Where BP had concluded that E&amp;A costs should continue to be carried in respect of projects where licences had expired, we obtained appropriate evidence that there was ongoing correspondence with the relevant regulatory bodies, as referred to in Note 1 to the financial statements, to support management's judgement. We also confirmed management's view that they did not consider that the development of any of their assets is inconsistent with BP's strategy and stated climate change ambitions.</p>

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**Accounting for structured commodity transactions (SCTs) within the integrated supply and trading function (IST), and the valuation of other level 3 financial instruments, where fraud risks may arise in revenue recognition**

Key audit matter description	How the scope of our audit responded to the key audit matter
<p>In the normal course of business, the integrated supply and trading function (IST) enters into a variety of transactions for delivering value across the group's supply chain. The nature of these transactions requires significant audit effort be directed towards challenging management's valuation estimates or the adopted accounting treatment.</p> <p><i>Accounting for structured commodity transactions:</i> IST may also enter into a variety of transactions which we refer to as SCTs. We generally consider a SCT to be an arrangement having one of the following features:</p> <ul style="list-style-type: none"> <li>a) two or more counterparties with non-standard contractual terms;</li> <li>b) multiple commodity-based transactions; and/or</li> <li>c) contractual arrangements entered into in contemplation of each other.</li> </ul> <p>SCTs are often long-dated, can have a significant multi-year financial impact, and may require the use of complex valuation models or unobservable market inputs when determining their fair value, in which case they will be classified as level 3 financial instruments under IFRS 13, Fair Value Measurement.</p> <p>There are inherent risks in the accounting for SCTs as these contracts are often complex and the associated accounting considerations often feature multiple elements, which are subject to management judgement, that will have a material impact on the presentation and disclosure of these transactions on the primary financial statements and key performance measures, including in particular whether finance debt should be recognized. We have identified the accounting for SCTs as a significant audit risk.</p> <p><i>Level 3 financial instruments:</i> Unlike other financial instruments whose values or inputs are readily observable and therefore more easily independently corroborated, there are certain transactions for which the valuation is inherently more subjective due to the use of either bespoke valuation models and/or unobservable inputs. These instruments are classified as level 3 financial assets or liabilities under IFRS 13. This degree of subjectivity also gives rise to potential fraud through management incorporating bias in determining fair values. Accordingly, we have identified these as a significant audit risk, and the area in which a fraud risk is most likely to arise in relation to revenue recognition.</p> <p>As at 31 December 2018, the group's total financial assets and liabilities measured at fair value were \$12.8 billion and \$8.9 billion, of which level 3 derivative financial instruments were \$3.6 billion and \$3.1 billion, respectively.</p>	<p><b>Accounting for structured commodity transactions:</b></p> <p>For structured commodity transactions, we performed audit procedures to:</p> <ul style="list-style-type: none"> <li>• Evaluate the design, implementation and operating effectiveness of controls related to the review of such non-standard transactions, including the: <ul style="list-style-type: none"> <li>• New activity integration control, which is designed to evaluate and approve the appropriateness of the new activity; and</li> <li>• Accounting policy review, which is designed to evaluate the appropriateness of accounting treatment in line with published IFRS accounting literature.</li> </ul> </li> <li>• Develop an understanding of the commercial rationale of the transactions through review of executed transaction documents and discussions with management.</li> <li>• Perform a detailed accounting analysis for a sample of structured commodity transactions involving significant day 1 profits, working capital arrangements, offtake arrangements and/or commitments.</li> </ul> <p>To assess the appropriateness of the accounting treatment of SCTs, we embedded technical accounting specialists on the audit team to assist in performing an assessment of the treatment applied by management.</p> <p><b>Other level 3 financial instruments:</b></p> <p>To address the complexities associated with auditing the value of level 3 financial instruments, our team included valuation specialists having significant quantitative and modelling expertise to assist in performing our audit procedures. Our valuation audit procedures included the following control and substantive procedures: We tested the design and operating effectiveness of the group's valuation controls including the:</p> <ul style="list-style-type: none"> <li>• Model certification control, which is designed to review a model's theoretical soundness and the appropriateness of its valuation methodology; and</li> <li>• Independent price verification control, which is designed to review the appropriateness of valuation inputs that are not observable and are significant to the financial instrument's valuation.</li> </ul> <p>We performed substantive valuation testing procedures at interim and year-end balance sheet dates, including:</p> <ul style="list-style-type: none"> <li>• Developing independent estimates, using externally sourced inputs and challenger models to evaluate against management's fair value estimates by evaluating whether the differences between our independent estimates and management's estimates were within a reasonable range;</li> <li>• Evaluating management's valuation methodologies against standard valuation practice and analysing whether a consistent framework is applied across the business period over period; and</li> <li>• Benchmarking management's input assumptions against the expected assumptions of other market participants and observable market data.</li> </ul>
<p><b>Key observations</b></p>	<p>We reviewed the features of 10 SCTs and determined that the accounting adopted for each of these was appropriate and in accordance with IFRS.</p> <p>We concluded that management's valuations relating to level 3 instruments were appropriate.</p> <p>We did not identify any transactions, valuation estimates or accounting entries which were the result of fraudulent misrepresentation of revenue recognition.</p>

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<b>User access management controls relating to financial systems</b>	
<b>Key audit matter description</b>	<b>How the scope of our audit responded to the key audit matter</b>
<p>The group's financial systems environment is complex, with 107 separate systems scoped as being relevant for the group audit. In addition, during the year, BP changed one of its key IT service providers.</p> <p>Due to the reliance on financial systems within the group, controls over system user access are critical to maintaining an effective control environment.</p> <p>As a result of our procedures, we identified a number of deficiencies relating to user access management, both within the group and the group's IT service organizations (together 'access deficiencies'). The access deficiencies identified increase the risk that individuals within the group and at service organizations had inappropriate access during the period. The existence of deficiencies during the year and at the year end, and the transition of the main IT service organization from one supplier to another during the year, result in an increased risk that data and reports from the affected systems are not reliable. The issues identified impact all components within the scope of our group audit.</p> <p>The group put in place a programme of activities to remediate the deficiencies, which extends into 2019. Accordingly, management also identified mitigating and compensating controls, and in particular established controls to analyse, through exploitation analyses, whether inappropriate access had been exploited during the year, working with both the legacy and new IT service organizations.</p> <p>The user access management controls are pervasive to the group's operations and accordingly the level of risk ascribed to our work in this area is dependent on the nature and complexity of the control itself and balances within the financial statements the control addresses.</p>	<p>We obtained an understanding of management's processes and relevant financial systems and tested the associated general IT controls. This testing led us to identify a number of deficiencies, notably in relation to user access.</p> <p>In responding to the identified deficiencies in user access we have used our teams of IT and internal control specialists to:</p> <ul style="list-style-type: none"> <li>• Test the controls that management has implemented or re-designed in order to remediate the deficiencies;</li> <li>• Assess and test the alternative or compensating controls that management has identified as mitigating access deficiencies, including the direct assessment of those controls operated by the legacy and new IT service organizations and identified business controls that do not rely on information that is potentially affected by the access deficiencies; and</li> <li>• Determine the impact that utilizing inappropriate levels of access could feasibly have had on the affected systems including assessing the likelihood of inappropriate user access impacting the financial statements, and testing controls implemented by management to identify instances of the use of inappropriate access, working with both the legacy and new IT service organizations.</li> </ul>
<b>Key observations</b>	<p>Our review of the analysis management performed to identify whether the access deficiencies were exploited during the year did not identify instances where such access had been used inappropriately.</p> <p>As a result, we were satisfied with the results of the remediation to date and mitigation activities such that we continued to adopt an audit approach which places reliance on the effectiveness of financial controls and which, under our methodology, enables us to apply lower sample sizes in our substantive testing.</p> <p>Management continues to work, with the support of the new IT service provider, to remediate fully the access deficiencies identified.</p>

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<b>Management override of controls</b>	
<b>Key audit matter description</b>	<b>How the scope of our audit responded to the key audit matter</b>
<p>We conducted a risk assessment for management override fraud risks by considering:</p> <ul style="list-style-type: none"> <li>• Potential areas where the group's financial statements could be manipulated;</li> <li>• Pressures or incentives to achieve certain IFRS or non-GAAP measures due to the remuneration arrangements of people in Financial Reporting Oversight Roles (FRORs), including management and senior executives;</li> <li>• Potential for inappropriate accounting estimates and judgements; and</li> <li>• Accounting for significant unusual transactions and estimates arising from changes to the business.</li> </ul> <p>Our response to the risk of management override of controls included testing the appropriateness of journal entries recorded in the general ledger. We identified control deficiencies at components where testing was performed and as a result, our audit approach required adjustment. Management remediated the control deficiencies identified where it was possible to do so. Some remediation activity will continue into 2019 and accordingly, management also directed us to other compensating controls which they considered to mitigate the risks, which we subsequently tested. This had a bearing on the allocation of resources in the audit, and the direction of effort of the audit team. Accordingly, we identified this as a key audit matter.</p>	<p>We tested the relevant primary and, where necessary, compensating controls that management identified as responding to the risk of fraudulent journal entries.</p> <p>In addition, we have:</p> <ul style="list-style-type: none"> <li>• Made inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.</li> <li>• Identified and tested relevant entity-level controls, in particular those related to the BP Code of Conduct, whistleblowing (BP OpenTalk) and controls monitoring financial reporting processes and financial results.</li> <li>• Used our data analytics tools to select journal entries and other adjustments made at the end of a reporting period or otherwise having characteristics which are associated with common fraud schemes for testing.</li> <li>• Tested journal entries and other adjustments recorded in the general ledger throughout the period, with a particular focus on adjustments that occur late in the financial close process.</li> </ul> <p>We have reviewed accounting estimates for bias and evaluated whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. A number of the most significant estimates are covered by the other Key Audit Matters set out above. This assessment included:</p> <ul style="list-style-type: none"> <li>• Evaluating whether the judgements and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of BP's management that may represent a risk of material misstatement due to fraud; and</li> <li>• Performing a retrospective review of management judgements and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.</li> </ul> <p>We considered whether there were any significant transactions that are outside the normal course of business, or that otherwise appear to be unusual due to their nature, timing or size.</p> <p>The risks and responses to the revenue recognition risks within the integrated supply and trading function are set out above.</p>
<b>Key observations</b>	<p>The nature of the identified deficiencies over journal-entry controls varies from business to business, so there is no single root cause. At the year end:</p> <ul style="list-style-type: none"> <li>• In some businesses these operating effectiveness deficiencies were able to be remediated by management and our testing of the remediation concluded it was effective.</li> <li>• In other businesses the deficiencies could not be quickly remediated and management identified direct and precise compensating controls to mitigate the design deficiencies identified. These compensating controls included low-level analytical reviews (e.g. individual asset reviews), controls over closing balances, period-end analytical review controls, and certain automated business controls. Our testing of these compensating controls concluded that they were, in combination, appropriately designed and implemented and that they were operating effectively for the period.</li> </ul> <p>Our substantive testing of the journal entries and other adjustments, selected through the use of data analytics tools, did not identify any inappropriate items, and accordingly we concluded that there was no evidence of management override.</p> <p>We did not identify any evidence of overall bias or any significant unusual transactions for which the business rationale (or the lack thereof) of the transaction suggested that it may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.</p>

#### **Our application of materiality**

We define materiality as the magnitude of misstatement in the financial statements that could reasonably be expected to influence the economic decisions of a reasonably knowledgeable user. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

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## Appendix H: KAMs vs CAMs

# CAM versus KAM—A Distinction without a Difference?

### Making Judgments in Reporting Critical Audit Matters

*Eva K. Jermakowicz, PhD, CPA, Barry Epstein and Sridhar Ramamoorti*

Source: CPA Journal

Since the last economic downturn, attention has turned to the auditor's report, which had remained largely unchanged for decades. In response to a perceived desire for more information and judgment from auditors, regulators—at first internationally and then in the United States—added significant new requirements and disclosures. The authors provide a comprehensive look at both U.S. and international standards for "critical/key audit matters," and discuss the challenges and potential benefits of implementation.

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In the wake of the 2008 global financial crisis, many investors and others called for the auditor's report to be made more informative—in particular by having auditors provide more relevant and useful information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate. Consequently, the form and content of the auditor's report is about to change in many jurisdictions.

On June 1, 2017, the Public Company Accounting Oversight Board (PCAOB) adopted a new standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, Release 2017-001, which supersedes portions of the extant AS 3101, *Reports on Audited Financial Statements*, and makes related amendments to other PCAOB standards. The new standard will impose significant changes to the existing auditor's report. In particular, the auditor's report will now include a description of "critical audit matters" (CAM), explaining the especially challenging, subjective, or complex concerns pertaining to the financial statement accounts and disclosures examined. As approved by the SEC on October 23, 2017, the updated AS 3101 only affects audits conducted under PCAOB standards. The AICPA's Accounting Standards Board (ASB) has, however, already

proposed a provision in its new audit report akin to the CAM, which might be either optional or required under certain circumstances.

In 2014, the International Auditing and Assurance Standards Board (IAASB) adopted International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, which included a new requirement for auditors to communicate "key audit matters" (KAM) selected from among the most significant matters communicated to those charged with governance, such as the audit committee. This requirement became effective for audits of financial statements of listed companies for periods ending on or after December 15, 2016.

In 2014, the European Union adopted new extended audit report (EAR) requirements for audits of public-interest entities to include a description of the most significant assessed risks of material misstatements, including those due to fraud, and the auditor's responses. Also required are a statement that the auditor remained independent of the audited entity and a disclosure of auditor tenure. The Financial Reporting Council (FRC) in the United Kingdom incorporated the EU and IAASB requirements in its 2013 auditor reporting rules. The FRC has supported EARs mainly as "a response to the post-2008 financial crisis and the need to enhance confidence in financial reporting and auditing" (*Extended Auditor's Reports: A Further Review of Experience*, January 2016, <http://bit.ly/2AUdAeP>). The FRC adopted the IAASB's definition of key audit matters and stipulated that risks of material misstatement, as determined under both its existing requirements and those of the EU, are key audit matters under that definition.

## Background of the Auditor's Reporting Model

The purpose of an audit is to enhance the intended financial statement user's degree of confidence. In the United States, the form of the auditor's report has changed little since the 1940s; it describes the nature of the audit and addresses whether the financial statements are fairly presented or not, in accordance with an applicable financial reporting framework. For years, changes have been urged (e.g., the Cohen Commission in 1974, the Treadway Commission in 1985) to improve overall communication to financial statement users, but the only resulting change has been the addition of a paragraph explaining the scope of the audit in greater detail. For public companies, there have been two changes to the standard auditor's report applicable to most SEC issuers since the 1980s: the adoption of the PCAOB's Auditing Standard 1, and the establishment of requirements for auditors to report on internal control over financial reporting, as directed by sections 103 and 404 of the Sarbanes-Oxley Act of 2002. The PCAOB has found, however, that "many investors indicated that auditors have unique and relevant insight based on their audits and that auditors

should provide information about their insights in the auditor’s report to make the report more relevant and useful” (PCAOB Release 2013-005, Aug. 13, 2013, <http://bit.ly/2mu3Q6H>). The board also acknowledged that one of the most frequently suggested areas for additional auditor reporting to investors is “matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty” (Release 2017-001, <http://bit.ly/2D4FQ3E>).

AS 3101 retains the pass/fail opinion of the existing auditor’s report, but significantly changes its form and content—most importantly, expanding it to include CAMs. Items that would be reportable as CAMs include the allowance for sales returns (revenue recognition), the valuation allowance for deferred tax assets, and the fair value of fixed maturity, not actively traded securities held as investments (Release 2013-005); other CAMs might relate to goodwill impairment, accounting for acquisitions, the allowance for loan losses, the valuation of defined-benefit plan pension assets and liabilities, the effects of new accounting standards, or the going concern assessment. The standard also requires disclosure of auditor tenure, as well as other perceived improvements that clarify the auditor’s role and responsibilities, provide additional information about the auditor, and make the auditor’s report easier to comprehend (Release 2017-001).

The standard will generally apply to audits conducted under PCAOB standards; however, communication of CAMs will not be required for audits of emerging growth companies; brokers and dealers; investment companies other than business development companies; and employee stock purchase, savings, and similar plans. All provisions other than those related to CAMs will take effect for audits of financial statements for fiscal years ending on or after December 15, 2017. Provisions related to CAMs will take effect for fiscal years ending on or after June 30, 2019, for large accelerated filers, and for fiscal years ending on or after December 15, 2020, for all others.

Enhancing the “pass/fail” model in the proposed standards by having auditors report on CAMs represents the most significant change in auditor reporting in decades. Many have urged the PCAOB to work together with other regulators and standards setters to achieve international convergence. Although the auditor reporting requirements of other regulators and standards setters—such as the IAASB and the FRC—differ in certain details, in many respects the initiatives are similar to the PCAOB’s final standard and will result in essentially similar enhancements. In a parallel fashion, despite jurisdictional differences in the processes of identifying a CAM/KAM, the commonalities in the underlying criteria could result in similar outcomes (PCAOB Release 2016-003, May 11, 2016, <http://bit.ly/2AUu7iS>). Deciding which matters to highlight as CAM/KAMs, and what auditors should say about them, will be critical in achieving the intended improvements.

## Defining a CAM/KAM

The definition of a CAM/KAM leaves what auditors may consider to be critical or key largely to judgment. Under AS 3101, CAMs are matters arising from the audit of the financial statements that have been communicated or were required to be communicated to the audit committee, are “related to” auditing accounts or disclosures that are material to the financial statements, and involve especially challenging, subjective, or complex auditor judgment. The final standard was modified to limit it to matters that are material to the financial statements, in response to concerns that auditors might otherwise be required to communicate information that management is not required to disclose. Some commenters stated that communicating immaterial matters would lead management to revise its disclosures to include a discussion of any matter identified as critical, regardless of materiality, or weaken and obscure the auditor’s opinion because such matters would be irrelevant to investors and other financial statement users. “Related to” clarifies that a CAM could be an element or aspect of an account or disclosure in the financial statements and does not necessarily need to correspond to the entire account or disclosure. For example, the auditor’s evaluation of the company’s goodwill impairment assessment could be a CAM; it would relate to goodwill because impairment is an aspect of that account. In addition, a CAM does not need to relate to a single account or disclosure, but could relate to several, or have a pervasive effect on the financial statements as a whole. Thus, the auditor’s evaluation of the company’s ability to continue as a going concern would be a CAM.

Conversely, a matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a CAM. For example, a potential loss contingency that was communicated to the audit committee but determined to be remote and not disclosed in the financial statements, a potential illegal act for which no disclosure was required, or the determination that there is a significant deficiency in internal control over financial reporting could not be a CAM.

The IAASB adopted a more principles-based approach to the definition of a KAM than the PCAOB did in defining a CAM, although the frameworks for determining a CAM/KAM are substantially similar and begin with those matters communicated or required to be communicated to the audit committee. Under ISA 701, KAMs are defined as those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Although materiality is not included in the definition of a KAM, paragraph A29 of ISA 701 notes that the importance of the matter to the intended users’ understanding of the financial statements as a whole, and in particular its materiality to the financial statements, may be relevant to determining the relative

significance of a matter communicated with those charged with governance, and therefore whether such a matter is a KAM.

## Determining Whether a Matter Is a CAM/KAM

Determining which, and how many, matters in an audit report required especially challenging, subjective, or complex auditor judgment is itself a matter of professional judgment. According to the PCAOB, a CAM is determined using a principles-based framework, and the level of auditor effort will depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and the company's accounting and control systems. In general, the greater the number of matters initially perceived as being CAMs, the more auditors may need to reconsider whether each of these matters actually meets the definition.

The final PCAOB standard does not specify any items that would of necessity constitute CAMs. For example, the standard does not provide that all matters determined to be "significant risks" under PCAOB standards would be CAMs, as not every significant risk would involve especially challenging, subjective, or complex auditor judgment. Similarly, not all material related-party transactions or matters involving the application of significant judgment or estimation by management will constitute CAMs. Disclosure of a CAM must be informative, will reflect differences in auditors' experiences and competencies, and should limit the extent to which expanded auditor reporting could duplicate management's report. To the extent that CAMs are to be cited, this decision in itself should also be informative.

A KAM should be specific to the entity and consistent with the audit having been performed in order to provide relevant and meaningful information to users. Therefore, ISA 701 includes a two-step process using a judgment-based framework to help auditors determine which matters are KAMs. This framework was developed to focus auditors on areas about which investors and other users have expressed interest, in particular on areas that involve the most significant or complex judgments by management and areas of auditor focus in accordance with the risk-based approach embraced by the ISAs (*The New Auditor's Report: A Comparison between the ISAs and the U.S. PCAOB Reproposal*, May 2016, <http://bit.ly/2FsXSuJ>).

For the most part, the specific factors and other considerations underlying an auditor's determination of which matters are CAMs/KAMs are similar under both approaches. In addition to the factors in **Exhibit 1**, which auditors are specifically required to take into account in determining a KAM, ISA 701 provides substantial guidance to support auditors'

decision making. In accordance with the IAASB’s standards, this application and other explanatory material is relevant to the proper application of the requirements.

## EXHIBIT 1

### Determining a CAM/KAM

PCAOB’s AS 3101	IAASB’s ISA 701
<p>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:</p> <ul style="list-style-type: none"> <li>• The auditor’s assessment of the risks of material misstatement, including significant risks</li> <li>• 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</li> <li>• The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions</li> <li>• The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures</li> <li>• 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</li> <li>• The nature of audit evidence obtained regarding the matter.</li> </ul> <p><b>Note:</b> It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.</p>	<p>The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:</p> <ul style="list-style-type: none"> <li>• Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised)</li> <li>• Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty</li> <li>• The effect on the audit of significant events or transactions that occurred during the period.</li> </ul> <p>The auditor shall determine which of the matters determined in accordance with the requirement above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.</p>

Source: AS 3101 para. 12, ISA 701 paras. 9, 10

Source: AS 3101 para. 12, ISA 701 paras. 9, 10

## Communicating a CAM/KAM

Because the determination of a CAM/KAM is linked to principles-based requirements and relies on auditor judgment, both the IAASB and PCAOB have set out specific requirements to assist auditors in documenting those judgments. AS 3101 requires CAMs to be communicated for audits conducted under PCAOB standards, with the exceptions noted above. Auditors are required to communicate in the auditor's report any CAM arising from the current period's audit, or state that the auditor determined that there are no CAMs. Additionally, auditors may include a CAM for prior periods when they decide it is appropriate.

Under ISA 701, auditors of financial statements of listed entities are required to communicate KAMs. Laws, regulations, or auditing standards in a particular jurisdiction may extend the requirement to communicate KAMs to other entities, such as public interest entities, public sector entities, entities in a particular industry, or all entities. The ISAs also allow for auditors to communicate KAMs for entities other than listed entities, even absent a requirement to do so.

The communication of CAMs/KAMs should be tailored to the facts and circumstances of the individual audit engagement, as seen in [Exhibit 2](#). The number of CAMs/KAMs that will be communicated may be affected by the complexity of the entity, the nature of the entity's business and environment, and the facts and circumstances of the audit engagement. Under both approaches, there will likely be at least one CAM/KAM communicated in the auditor's report; however, both the IAASB and PCAOB acknowledge that there may be circumstances where there are no CAM/KAMs to report, and both require a statement to that effect in the auditor's report in such cases. Both the IAASB and PCAOB require the communication of CAM/KAMs only for the audit of the current period, but guidance for both standards indicates that it may also be useful for auditors to consider whether a CAM/KAM in the prior period continues in the current one.

### ***EXHIBIT 2***

Communicating a CAM/KAM

PCAOB Standard AS 3101	IAASB Standard ISA 701
<p>For each CAM communicated in the auditor's report, the auditor must:</p> <ul style="list-style-type: none"> <li>• Identify the critical audit matter</li> <li>• Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter</li> <li>• Describe how the critical audit matter was addressed* in the audit</li> <li>• Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.</li> </ul>	<p>The description of a KAM shall include a reference to the related disclosures, if any, in the financial statements and address:</p> <ul style="list-style-type: none"> <li>• Why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM</li> <li>• How the matter was addressed in the audit.</li> </ul>
<p>*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.</p>	

Source: AS 3101, para. 14; ISA 701, para. 13

Source: AS 3101, para. 14; ISA 701, para. 13

## Benefits and Challenges

According to the PCAOB, the disclosure of CAM/KAMs will benefit the market directly, by allowing market participants to make better-informed decisions, as well as indirectly, because some reporting parties may change their behavior in positive ways after information is disclosed.

Auditor communication of CAM/KAMs should reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management, about the company's financial performance, thereby reducing the cost of acquiring information for financial statement users and enhancing the following:

- Communication between auditors and investors, as well as management
- Transparency, audit quality, and information value



- Attention by management and financial statement preparers to disclosures referencing the auditor's report
- User understanding, consumption, and confidence in audit reports and financial statements
- Long-term investors' understanding of the company
- Support for investor decisions on ratification of the auditor
- Ability of investors to monitor management and the board of directors' stewardship of the company.

Increased disclosures should also provide some auditors, management, and audit committees with additional incentives to change their behavior in ways that may enhance audit quality, and ultimately financial reporting quality, in the public interest. The selection and wording of CAM/KAMs, however, require the highest level of judgment from the audit team and will likely be subject to multiple levels of internal review by audit firms. This will likely add significant costs and delivery time to audit reports, thus pushing deadlines and putting additional pressure on auditors to finish early enough to ensure timely filings. Thus, potential challenges include the following:

- Increased audit costs
- Increased liability for auditors
- Effects of increased attention to CAMs/KAMs (certain investors may misinterpret discussion of these issues as an indication of a problem, even if the audit results in a clean opinion)
- A "first mover" disadvantage when CAM/KAMs reported by later filers in the same industry are omitted
- More time needed to issue the auditor's report, and commensurate filing deadline pressures
- The risk of disclosing information not disclosed by management
- A chill in communication between auditors, management, and the audit committee if there are disagreements on what a CAM is
- Impact on management disclosure and discrepancies between management's disclosures and CAMs
- Over standardization of CAM/KAMs, which would nullify their purpose.

## Experience in the United Kingdom

The FRC has reviewed a number of extended audit reports over the first two years of implementation of ISA 701 and observed that investors greatly value the information provided in those reports, even identifying certain descriptions of risks that they found to be more useful than others. Investors value reports that avoid the use of boilerplate language and provide information about the specific outcomes of the audit work, the audit findings,

and the mandatory descriptions of the audit process. Materiality, however, is still a challenging area.

A U.K. association of investment managers has recognized in an annual awards ceremony the most innovative auditor's reports. A 2017 ICAEW report cautions, however, that these achievements are still fragile and that the whole system needs support and encouragement to avoid boilerplate and promote further enhancements. Moreover, media, legal and disciplinary reactions to scandals such as Rolls-Royce will affect the development of EAR in the future (*The Start of a Conversation: The Extended Audit Report*, ICAEW, <http://bit.ly/2ECsRTV>).

The Rolls-Royce 2014 audit report, published by KPMG, won the Investment Association award for the disclosure of the risk of material mis-statements. The 2015 report, which included an audit risk map for the first time, has been identified as a leading example of innovative development of the audit report. Nevertheless, in January 2017, Rolls-Royce agreed to pay £671 million in penalties to settle bribery and corruption charges, and the FRC began investigating KPMG's conduct with respect to its audit of Rolls-Royce's financial statements between 2010 and 2013.

In 2014, KPMG considered that there was adequate disclosure in the financial statements on the matter of corruption, but nevertheless decided to recognize a bribery and corruption KAM. Could the EAR with KAMs result in more harm than benefit to the enterprise, shareholders, and society? The KAM for bribery and corruption reported by KPMG was arguably written with a view to the company's legal interests rather than what an investor would want to be informed about by a truly independent representative with privileged access.

***Expanding the audit report with communication of CAMs/KAMs is expected to increase competition among audit firms, and thereby to enhance the value of the audit to investors and elevate the overall level of confidence in audited financial reports.***

The FRC has stated that the two purposes of EARs are to inform investors and to give them greater confidence in the audit. To the contrary, the bribery and corruption KAM failed to significantly inform investors (while giving the impression of doing so), encouraging a misplaced confidence in view of the roughly \$1 billion in fines and claw-backs mandated by the Rolls-Royce deferred prosecution agreements of January 2017 (ICAEW 2017; Julia Kollwe, "Accounting Watchdog to Investigate KPMG over Rolls-Royce Audit," *Guardian*, May 4, 2017, <http://bit.ly/2nbKoev>).

Notwithstanding such scandals, no noticeable effect of recognition of KAMs has yet been seen on these reports. The risk appears to be, in many respects, not dissimilar to that which has long existed for a short-form report, and disclosure of KAMs may indeed help auditors manage their risks in auditing large companies. This concern deserves ongoing monitoring and possible reassessment.

## Enhancing Audit Quality

Many believe that it is long overdue for auditors to provide meaningful information about audits to the investing public. Extensive regulation of audit practice has arguably been accompanied by commoditization of the audit and contributed to extensive auditing failures (Shyam Sunder, "Minding Our Manners: Accounting as Social Norms," *British Accounting Review*, December 2005, <http://bit.ly/2myy888>). Audit committees and investors should have an understanding of the auditor's perspective on the financial statements, including significant issues that arose in the audit and how they were resolved, areas of greatest risk, significant estimates and judgments, restatements, and materiality assessments.

Reducing the level of information asymmetry between management and investors could result in more efficient capital allocation and lower the average cost of capital. In addition, expanding the audit report with communication of CAMs/KAMs is expected to increase competition among audit firms, particularly in the area of professional skepticism, and thereby to enhance the value of the audit to investors and elevate the overall level of confidence in audited financial reports.

The determination of CAMs/KAMs is highly dependent upon auditor judgment, which is the application of relevant training, knowledge, and experience—within the context provided by auditing, accounting, and ethical standards—in making informed decisions about the appropriate courses of action under the circumstances of the audit engagement. The decision as to which matters in the audit are "challenging, subjective, or complex" or "most significant" will necessarily be made by the engagement team, especially the engagement partner. One engagement partner with extensive knowledge and experience might not view certain matters as reportable CAMs/KAMs, while another might. Both the PCAOB and the IAASB provide extensive guidance for deciding which matters to highlight as CAMs/KAMs and what auditors should say about them.

Many believe that, in order to strengthen and improve global audit standards, the PCAOB should align its auditing standards with the IAASB standards to the maximum extent possible (comment letter to PCAOB Release 2016-003, California State Teachers' Retirement System, Aug. 12, 2016, <http://bit.ly/2ECp6h8>; comment letter to PCAOB Release 2016-003,

Institute der Wirtschaftsprüfer, Aug. 15, 2016, <http://bit.ly/2DDUsYO>). Although the PCAOB standard is similar to the IAASB standard, some of the terms and definitions differ. Based on auditor judgment and professional skepticism, this could result in two different reporting models and divergent views in some instances with respect to what key matters are disclosed. The IAASB's definitions of materiality are also broader and not consistent with the legal concept of materiality in the United States adopted by the PCAOB and FASB and embedded in the definition of a CAM. Because the definition of a CAM/KAM will affect auditors' behavior and attitude, the inclusion of a materiality consideration in the definition of a CAM may result in a narrower population of candidate matters than under the IAASB's standards or approaches in other jurisdictions.

# Appendix I: Concerns about CAM's

## Critical Audit Matters: The Games Are On

<https://goingconcern.com/critical-audit-matters-the-games-are-on/>

By Jim Peterson

As a guest here [recently](#) I took a look at the accumulating experience with extended auditors' reports—the additional paragraphs that under international standards describe [key audit matters](#) (aka [critical audit matters](#) under the Public Company Accounting Oversight Board's standards in the United States).

There I noted a major gap—nobody has yet asked whether investors actually pay any attention or give any value to the extra verbiage, while the evidence builds that they do not, notably the lack of indicative share price moves at Steinhoff Group in South Africa and the U.K.'s Thomas Cook.

If investors show no real concern for KAMs and CAMs, who does—and is auditor behavior affected?

With those questions open, studies are emerging on the first wave of U.S. CAMs. Examples include [Deloitte](#) this summer, on 52 large companies with fiscal years ending on June 30, 2019; a second in September by [Audit Analytics](#) that looked at 65 large-company filings, followed up and [expanded](#) in November; and a [third](#) reported in November by Accountancy Europe, summarizing the recent experiences with KAMs in Europe.

The Deloitte study and its commentary focused on the substance of the CAMs—the most common are goodwill and intangibles (35%), revenue (19%), and income taxes (15%)—headline subjects also observed by Audit Analytics.

As a topic for a day to come, it may be safely predicted that another year of experience will confirm these early indications of herding toward a converged set of common CAMs, and a booming bull market in boilerplate language. Meanwhile, there are implications simply in the *number* of reported CAMs and the potential for gaming involved—something worthy of attention by students of the dynamics between large-company auditors and the PCAOB.

The Deloitte study reported an average of 1.8 CAMs for each reporting company, with a distribution ranging from none at all or only one to an outlying maximum of seven or eight—figures consistent with the Audit Analytics finding of 1.9 each and the average of just over two each for the 20 largest U.S. companies reported.

For the auditors themselves, the simple question of optimal CAM frequency has salience at each of two stages—both when a company blows up in scandal, and also as the auditors go through the antagonistic process of PCAOB inspection. The first is because when challenged in a courtroom, the entire CAM process will have generated hostages to the auditors' fortune and a litigation nightmare, with hostile lawyers pressing the perpetual question, "Where were the auditors?"

That disputing will likely trace to one of the typically common CAM topics—goodwill and intangibles (see Steinhoff), or the legitimacy of revenue (see [Under Armour](#)), or the vexed question whether and when an audit report should have been qualified (see [Thomas Cook](#)). Closing jury arguments will be built on one of two themes:

- If a CAM had been issued: "They saw it, they addressed it, and they still botched it."
- Or if not, on the other hand, a back-footed auditor defending a report with few CAMs or none would be called to answer for a client's fraudulent concealment: "There were billions in falsified transactions—how could they have missed them all?"

In the second case, although the level of PCAOB compliance might be thought of quotidian nuisance, there is the unfortunate [frequency](#) of inspected firms to manipulate their working paper files ahead of the inspectors—all the way to the prison-bound criminality involved in the [theft of PCAOB inspection lists by personnel of KPMG](#).

As played straight most of the time, however, the auditors' CAM counts will be relevant in handling inspections, where commentators since Sarbanes Oxley's enactment in 2002 are recognizing that box-ticking and checklist fulfillment now rule (see [here](#) and [here](#)).

In that context, "zero findings" would plainly be the wrong answer. A PCAOB inspector would be understandably incredulous over a public-company audit where *nothing* rose to CAM-level significance. Likewise, the presentation of only a single CAM would open the auditor to a nitpicker's prodding: "Out of all the issues you looked at, why only this one?"

Too many CAMs, of course, would provoke a different inspection issue—triggering the familiar maxim, “if everything is important, then nothing is important.”

A Goldilocks strategy emerges—firms will identify *two* CAMs at least, maybe *three* at most. Those numbers avoid the tail risks—too many or too few—while the inspectors can be entangled in extended discussions over competing priorities and resources, the interest level and reading tolerance of investors, and the length and complexity of audit reports. The gaming of that process and the accompanying negotiations can be prolonged until all players are cross-eyed with boredom and fatigue.

The result? Three or four years from now, a bright young PhD candidate will have an assured research topic and a glide-path along the tenure track, by compiling experiences under the rubric, “Who ever thought CAMs were a good idea?”

## Appendix J: Harvard Law

### Critical Audit Matters—What to Expect

Posted by Jennifer Burns, Deloitte & Touche LLP, on

Wednesday, May 8, 2019

The January 2019 edition of *On the board's agenda—The 2019 boardroom agenda: Something old, something new?* suggested that the coming change in audit reports related to “critical audit matters” or “CAMs” would be one of the top issues of board and audit committee focus this year. Audit reports for large accelerated filers will include a new section addressing CAMs beginning for audits of fiscal years ending on or after June 30, 2019, and for other public companies in 2020. This will be a dramatic change in auditor reporting and is expected to generate significant media attention, particularly in the first year of adoption. What is the board’s role with respect to CAMs? How are CAMs identified? What is being done to prepare for CAMs and what might boards expect? This post discusses these questions and highlights considerations for boards in advance of the first auditor reporting of CAMs this summer.

#### What is the role of the board with respect to CAMs?

While oversight of financial reporting is delegated to the audit committee, boards should remain engaged and understand which areas may be identified as CAMs; this can be achieved through regular communications with the audit committee, auditor, and management. Audit committees, in exercising their oversight role, should engage with the auditor throughout the audit—during planning, interim periods, and at year-end—to understand the CAMs and any issues that may arise that may change the ultimate conclusion regarding CAMs. In addition, the board should understand how management and investor relations are preparing for implementation of CAMs.

#### What is a CAM and how will auditors identify CAMs?

Under the standard adopted by the Public Company Accounting Oversight Board, a CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that:

- Relates to accounts or disclosures that are material to the financial statements AND
- Involves especially challenging, subjective, or complex auditor judgment. [\[1\]](#)

In considering whether the matter relates to accounts or disclosures that are material to the financial statements, a CAM may relate to an entire material account or disclosure, a component of a material account or disclosure, or to several accounts or disclosures.



The PCAOB's standard provides a non-exclusive list of factors to be considered in determining whether a matter involves especially challenging, subjective or complex auditor judgment. These factors include the risk of material misstatement, the nature and extent of audit effort required, including use of auditor specialists, and areas that involve significant estimation uncertainty. The auditor is required to also take into account other factors specific to the audit.

CAMs are only required to be identified in relation to the current period audit, although there is no prohibition on communicating CAMs for all periods presented.

### Changes to the Auditor's Report and CAMs

Steps the auditor takes to Identify CAMs:



For each CAM identified, the following must be communicated in the auditor's report:

- Identify the CAM,
- Describe the principal considerations that led to the auditor's determination that the matter is a CAM,
- Describe how the CAM was addressed in the audit, and
- Refer to the relevant financial statement accounts or disclosures that relate to the CAM.

- Factors to be taken into account when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:
- 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;
  - f. The nature of audit evidence obtained regarding the matter; and
  - g. Other factors specific to the audit.

## What areas are likely to be CAMs?

The more common CAMs will likely relate to areas involving a high degree of estimation, such as goodwill impairment, intangible assets, acquisitions, taxes, and illiquid investments. However, a CAM could be identified in an area that does not require significant estimation but instead represents an area of the audit that is especially challenging or an area that is more complex to audit. One example is auditing revenue where contract terms are complex (e.g., situations involving long-term contracts, several modifications to contracts, or multiple performance obligations). In such cases, the significant judgments involved in recognizing revenue may lead to the auditing of revenue being a CAM.

Further, there may be industry-specific matters that involve a high degree of estimation and are typically very material that may be common CAMs (e.g., in the banking industry, the allowance for loan loss or in the insurance industry, the liability reserve).

For each annual audit, the area(s) identified as CAMs may be new or may be similar to those for the prior year, depending upon the facts and circumstances of that particular year's audit. For example, if a CAM was identified in one year related to income taxes, it is possible that in the next year the area of income taxes no longer rises to the level of a CAM—even though income taxes remain as a line item in the financial statements. However, a matter wouldn't cease to be a CAM in the following year just because another matter rose to the level of a CAM (i.e., if both matters meet the definition of a CAM in the current year, both would be identified as CAMs).

## How will CAMs be described in the auditor's report?

For each CAM communicated in the auditor's report, the auditor is required to include introductory CAM language as prescribed by the PCAOB and to:

- Identify the CAM.
- Describe the principal considerations that led the auditor to determine that the matter is a CAM.
- Describe how the CAM was addressed in the audit.
- Refer to the relevant financial statement accounts or disclosures that relate to the CAM (or both accounts and disclosures).

In describing how the CAM was addressed in the audit, the auditor may describe, for example, (1) the auditor's response or approach that was most relevant to the matter and (2) a brief overview of the audit procedures performed. The PCAOB stated [\[2\]](#) in its release adopting the standard that CAM descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, the objective is to provide a useful summary, not to detail every aspect of how the matter was addressed in the audit. The description should be specific to the audit and clearly and concisely describe why the matter involved especially challenging, subjective or complex auditor judgment. The PCAOB expects that the auditor would identify at least one CAM in each audit, but it has acknowledged the possibility that no CAMs may be identified.

## How are auditors preparing for the implementation of CAMs?

Significant efforts are underway at public accounting firms, including Deloitte, to prepare for implementation—including the development of tools and guidance as well as performing “dry-runs” of the CAM requirements. Through the dry-runs, auditors are evaluating what matters might be CAMs, considering how CAMs might be drafted, and discussing potential CAMs with management and the audit committee—in effort to help make sure all understand and are prepared for the CAM requirement when it becomes effective.

Reporting CAMs will be a significant change—and advanced preparation will be beneficial to all involved. We believe some of the benefits and lessons learned so far in doing the dry-runs include:

- Audit professionals are gaining experience about the process of identifying CAMs—which should help result in a smoother implementation process.
- Deciding whether something is a CAM requires significant judgment and is specific to the circumstances of each audit. Therefore, what might be a CAM on one audit may not be a CAM on another audit.
- Drafting CAMs is not easy. For example, it can be difficult to convey concisely the essence of why a matter is a CAM, and to summarize the audit procedures performed in a manner that is informative, but not overly technical. The dry-runs have pointed out the importance of starting the drafting of CAMs early, so the end result is as clear and concise as possible.
- Sharing draft CAMs with members of management and audit committees is providing an opportunity to make sure there is a common understanding about what the requirements are and how the process and timing may work, as well as helping to set expectations regarding CAMs.
- Communicating with management and the audit committee throughout the process of identifying and drafting CAMs will be important. At the same time—the auditor is responsible for the language in the auditor's report.

In general, the dry-runs are also taking some of the angst out of the system—allowing auditors, management, and audit committees to be better prepared when the requirements become effective.

And speaking of effective dates, the phased in effective dates are very helpful in terms of preparing for implementation. With auditors of large accelerated filers adopting first for fiscal years ending on or after June 30, 2019, lessons learned can be shared with all stakeholders, which may help to ease implementation process for others. For example, December 31 year-end large accelerated filers will be able to benefit from the experiences gained through the first CAMs publicly reported in the summer and fall of 2019.

## What may be some of the biggest challenges regarding communication of CAMs in the auditor's report and how can these challenges be overcome?

One of the challenges that has been raised by some relates to whether CAMs will become boilerplate over time. While CAM topics are likely to be similar, CAMs are required to be specific to the audit and, therefore, are less likely to become boilerplate. For example:

- The reasons why something is a CAM will vary. A CAM may relate to a particular aspect of an account or may arise due to something unique happening at the company.

- The types of audit procedures performed may be different.
- The reasons why the matter involved especially challenging, subjective, or complex auditor judgment may be different.

An area companies have been focused on is aligning their own disclosures with the auditor's potential CAM descriptions. The PCAOB has explained that auditors are not expected to provide information about the company that hasn't already been disclosed by the company, unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM. [3] As a result, CAM language in the auditor's report may need to be more descriptive than what the company has historically disclosed in order for the auditor to express why the matter resulted in it being a CAM. In such situations, companies may opt to include additional information in its disclosures. Having regular dialogue about the areas of potential CAMs and the potential CAM descriptions will help management as they consider their own disclosures.

Another challenge that is often raised is whether investors and analysts are prepared for the implementation of CAMs and whether they will understand what the CAMs mean. To help address this challenge, it is important for management, investor relations and communication teams, and those involved in the financial reporting process to understand the CAM requirements, so that they are prepared to address questions that may arise. For example, it is important to understand that the requirement to describe CAMs does not change the opinion in the auditor's report—CAMs are not "piecemeal" opinions on the individual areas identified, and the auditor's opinion will continue to be on the financial statements as a whole.

In addition, some have questioned whether CAMs will be consistent across industries and companies (and whether that should be an expectation). In certain industries, there may be certain areas that consistently rise to the level of a CAM (e.g., allowance for loan loss at a bank). However, the similarity may end with the topic of the CAM. As previously mentioned, the PCAOB standard requires CAMs to be particular to the individual audit. For example, what drives the auditor's conclusion as to why a matter is a CAM, the procedures performed to address the CAM, and the reasons why a matter was especially challenging, subjective or complex is likely to be unique in each situation.

## Conclusion

While the inclusion of CAMs is a significant development affecting auditor reports, adequate preparation and an active dialogue among auditors, audit committees, boards and management (including investor relations and communications teams) should help to facilitate a smooth transition to the new standard. We expect significant attention to be paid to the first reporting of CAMs, and as a result, boards should be prepared in advance so that they are less likely to be surprised by questions that arise. By understanding the CAM requirements and staying informed of the areas that may be identified as CAMs, directors will be prepared and will be providing value to their oversight of the company.

# Appendix K: AICPA article on Key Audit Matters for private companies

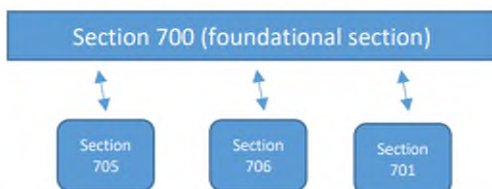


## New auditor reporting Standards

### What happened?

In May 2019, the AICPA Auditing Standards Board (ASB) issued, Statement on Auditing Standards (SAS) No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements* as a final standard. SAS No. 134 contains the following sections:

- **Section 700, *Forming an Opinion and Reporting on Financial Statements*** The foundational section that addresses the auditor's responsibility to form an opinion on the financial statements and prescribes the form and content of the auditor's report when issuing an unmodified "clean" opinion. ([Click here](#) for information about the foundational standard for audits of employee benefit plans subject to ERISA.) This section also includes an appendix of amendments to various AU-C sections relating to auditor reporting and disclosures.



- **Section 705, *Modifications to the Opinion in the Independent Auditor's Report*** Addresses the form and content of the report when the auditor concludes that a clean auditor's opinion in accordance with section 700 is not appropriate (qualified, adverse, or disclaimer of opinion).

- **Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*** Addresses additional communications in the auditor's report (emphasis-of-matter and other-matter paragraphs).

- **New! Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*** Addresses the auditor's responsibility to communicate key audit matters (KAMs) in the auditor's report when the auditor is engaged to do so. SAS No. 134 does NOT require the communication of KAMs.



SAS No. 134 will benefit users of audited financial statements by placing the auditor's opinion at the front of the report for added visibility and providing necessary transparency into the basis for the auditor's opinion and the responsibilities of both entity management and auditors

### What has changed?

SAS No. 134 replaces AU-C sections 700, 705 and 706 and introduces a new section 701. To enhance the communicative value and relevance of the auditor's report, the following key changes have been made:

#### ***Forming an Opinion and Reporting (Section 700 of SAS No. 134)***

- **Opinion section required to be presented first**, followed by the Basis for Opinion section.

- **Basis for Opinion section required to follow the opinion section**, including a statement that the auditor is required to be independent of the entity and to meet the auditor's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the audit.

- **Enhanced auditor reporting relating to going concern**, including a description of the respective responsibilities of management when required by the applicable financial reporting framework, and the auditor for going concern.

- **Amends AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern***, to include a separate section in the auditor's report, when substantial doubt exists, under the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern".

- **Expanded description of the auditor's responsibilities**, including the auditor's responsibilities relating to professional judgment and professional skepticism, and the auditor's communications with those charged with governance.



# At a glance

From the Audit & Attest Standards Team

## New auditor reporting Standards, page two

### What has changed? (continued)

- **Amends AU-C section 260, *The Auditor's Communication With Those Charged With Governance***, to require the auditor to communicate with those charged with governance about the significant risks identified by the auditor.

#### **Key Audit Matters (Section 701 of SAS No. 134)**

- When engaged to include key audit matters (KAMs), section 701 addresses both the auditor's judgement about what to communicate in the auditor's report and the form and content of such communication. GAAS does not require the communication of KAMs.

#### **Modifications to the Opinion (Section 705 of SAS No. 134)**

- Aligns the form and content of the auditor's report with the changes in section 700 of SAS No. 134 when the auditor concludes that a clean auditor's opinion in accordance with section 700 is not appropriate (qualified, adverse, or disclaimer of opinion). (Section 705 of SAS No. 134 does not change the existing requirements regarding circumstances in which a modification to the auditor's opinion is required, and for determining the type of modification to the auditor's opinion.)

#### **Emphasis-of-Matter and Other-Matter Paragraphs (Section 706 of SAS No. 134)**

- Clarifies the relationship between Emphasis-of-Matter (EOM) paragraphs and the communication of KAMs
  - When engaged to communicate KAMs, the use of the EOM paragraph is not a substitute for including the matter in the KAM section if the matter meets the definition of a KAM.
  - Using an appropriate heading is required. When KAMs are communicated, the heading is required to use the term "Emphasis of Matter"

### **Amendments Addressing Disclosures in the Audited Financial Statements**

- **Amends various AU-C sections** to focus auditor attention on disclosures throughout the audit process, including new requirements in AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements*, AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks*, and section 700.
- **Includes enhanced application material** in these and several other AU-C sections to assist auditors in addressing the practical challenges arising from the evolving nature of disclosures.

### Other Related Projects

- **Proposed SAS *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports***, will supersede AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*, and will address the auditor's responsibilities relating to financial and nonfinancial information in an entity's annual report other than the financial statements and the auditor's report thereon. This proposed SAS would require a separate section be included in the auditor's report addressing other information.

### Next steps?

SAS No. 134 is effective for audits of financial statements for periods ending on or after December 15, 2020, with early implementation not permitted.

SAS No. 134 is available for auditors to read and consider in order to adequately prepare for implementation, and can be viewed on the AICPA's website under [recently issued standards](#).

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