Critical audit matters, or “CAMs,” have been an important topic of discussion among investors, auditors, public companies and audit committees since the Public Company Accounting Oversight Board (“PCAOB”) adopted Auditing Standard 3101 (“AS 3101”) on June 1, 2017. AS 3101 requires that an auditor of a public company communicate CAMs in any unqualified audit opinion relating to its audit of the company’s current period financial statements.1 AS 3101 went into effect for audits of large accelerated filers for fiscal years ending on or after June 30, 2019. This means that there is now a body of precedent for CAMs disclosures that large accelerated filers may draw on in preparing their annual reports for 2019.2 This body of precedent has been examined in a number of surveys that reporting companies will find useful.3 This alert provides a brief background of CAMs and discusses important takeaways and lessons learned from recent CAMs disclosures.

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1 AS No. 1301.

2 Communication of CAMs for audits of all other public companies, except emerging growth companies, are required in unqualified audit opinions for fiscal years ending on or after December 15, 2020. The PCAOB has also exempted registered brokers and dealers, registered investment companies other than business development companies, and employee stock purchase, savings, and similar plans from the CAM disclosure requirement. However, auditors of such exempted entities may voluntarily include communications of CAMs.

What are CAMs?

A CAM is any matter arising from an audit of a company’s financial statements that (1) was communicated, or required to be communicated, to the audit committee, (2) relates to accounts or disclosures that are material to the company’s financial statements, and (3) involved especially challenging, subjective or complex auditor judgment. The decision to identify a CAM is inherently fact-specific. The PCAOB has not identified any matter that would presumptively constitute a CAM.

The materiality of accounts or disclosures to the financial statements is to be assessed based on both quantitative and qualitative factors. For matters involving “especially challenging, subjective, or complex auditor judgments,” the PCAOB has provided a non-exclusive list of factors that should be considered by auditors, either alone or in combination, in determining what might be a CAM:

- the auditor’s assessment of the risks of material misstatement;
- the degree of auditor judgment related to areas of the financial statements that involved application of significant management estimation or judgment;
- the nature and timing of significant unusual transactions and the extent of the related audit effort and judgment;
- the degree of auditor subjectivity required in applying audit procedures or evaluating the results of the procedures;
- the nature and extent of audit effort required to address the matter, including the specialized skills or knowledge needed or the nature of consultations outside the engagement team on the matter; and
- the nature of audit evidence obtained regarding the matter.

The PCAOB notes that it is expected, in most audits, the auditor would determine that at least one matter involved “especially challenging, subjective, or complex auditor judgments.”

Important Takeaways from Recent Disclosures Regarding CAMs

To date, studies indicate that there have been more than 190 companies with filed audit reports discussing CAMs, and that, of that group, there have been an average of 1.73 CAMs in each audit report. The largest category of CAMs have related to goodwill and intangible assets, revenue, income taxes or acquisitions, although CAMs have also covered other areas, largely those involving estimates and the application of significant judgment. Based on these early findings, there are a number of trends and takeaways related to CAMs disclosures that year-end companies should keep in mind as they approach the 2019 fiscal year-end reporting season.

4 AS No. 1301.


6 See, e.g., CII Report, p. 4.
1. **The descriptions of CAMs in audit reports are uneven**

AS 3101 requires that for each CAM, the auditor must (a) identify the CAM, (b) describe the principal considerations that led the auditor to make the CAM determination, (c) describe how the CAM was addressed in the audit which may include the auditor’s response or approach to the matter, an overview and outcome of the audit procedures performed, and key observations with respect to the matter, and (d) refer to the relevant financial statement accounts or disclosures to which each CAM relates.

One study has noted unevenness in the level of descriptions provided in response to these requirements, which might suggest an area of future focus of the staff of the Securities and Exchange Commission (“SEC”).

2. **Dry runs are an important resource for companies**

One study indicates that 54% of companies have had dry run discussions with their auditors, involving management and/or the audit committee, and that these discussions have often led to additional disclosures or attention to controls. Dry runs permit management and audit committees to view draft CAMs and to set expectations about the new requirements, ultimately reaching a mutual understanding about implementation. The familiarity that companies gain with the CAM requirements from the dry run process is significant; one study found that 43% of audit committees that conducted a dry run identified additional controls that required implementation, and another 19% are considering making such changes.

3. **CAMs can be expected to warrant complementary disclosures by the company**

As may be expected due to their critical nature, CAMs are likely to implicate disclosures elsewhere in the Form 10-K. Studies confirm that many CAMs are also discussed in the company’s Risk Factors or Management’s Discussion and Analysis (“MD&A”). Overall, a substantial majority of companies stated that they would consider updating their financial disclosures.

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7 CII Report, p. 4–5.
8 Id. at 22.
9 Id.
10 Intelligize Report, p. 12.
12 Intelligize Report, p. 4.
13 Id. at p. 19.
statement disclosures in light of communicated CAMs and approximately half of large accelerated filers stated they would consider updating MD&A.\textsuperscript{14}

One study concluded that generally auditors appropriately identify the CAMs and describe the principal considerations that led to CAM identification, consistent with the PCAOB’s guidance.\textsuperscript{15} However, auditors may fail to describe fully how a particular CAM was addressed in the audit or refer to the relevant financial statement accounts or disclosures.\textsuperscript{16} If a CAM simply notes an internal control issue, for instance, the company may consider asking the auditor to disclose the changes that were made by the company to address the issue.

As an example, the auditor’s report in one company’s Form 10-K identified a corporate acquisition as a CAM due to significant management estimates and assumptions related to the fair value of intangible assets acquired.\textsuperscript{17} The company elected to disclose the (i) use of estimates and the valuation of acquired intangible assets in the notes to its financial statements,\textsuperscript{18} (ii) the uncertain value of intangible assets as a potential risk factor\textsuperscript{19} and (iii) an explanation of the company’s estimates and assumptions related to the transaction in MD&A.\textsuperscript{20} This is a good example of the kinds of complementary disclosure that public companies will want to consider in order to provide a contextualized presentation of the issues underlying the CAMs communicated in the reports of their auditors.

4. **Management predictions, estimates, assumptions, and valuations are easy targets for CAM status**

Management predictions, estimates, and assumptions are likely to involve possible CAMs because they require auditor judgment. One study found, for instance, 12.4% to tax contingencies, 6.7% to fair value of liabilities or equity, and 4.5% to inventory valuation and reserves.\textsuperscript{21} In these cases, the CAMs reference significant management assumptions or auditor subjectivity. For example, the auditor’s report for one company stated that the test for impairment of indefinite-lived intangible assets (trademarks) involved “significant management assumptions,” which in turn led to a high degree of auditor judgment and subjectivity, significant audit effort, and the use of professionals with specialized skills and knowledge.\textsuperscript{22} This is a good reminder for management to start conversations with auditors about areas involving significant

\textsuperscript{14} Id.

\textsuperscript{15} CII Report, p. 2.

\textsuperscript{16} Id. at pp. 3–4.


\textsuperscript{18} Id. at p. F-11.

\textsuperscript{19} Id. at p. 16.

\textsuperscript{20} Id. at p. 39.

\textsuperscript{21} Kral Ussery Report.

management estimates or judgment as early as possible, so both parties can be on the same page by the time CAMs disclosure is required.

Studies have determined that valuation of goodwill and intangible assets account for 27% and 35%, respectively, of all CAMs. In particular, the valuation of goodwill, customer relationships, and intellectual property (such as trademarks) often involve management assumptions or judgments. These assumptions and the underlying data must be tested for completeness, accuracy and relevance. As a result, we recommend management discuss valuations of intangible assets that are based on multiple assumptions with auditors early in the process.

5. Transactions often lead to multiple CAMs

Companies should also realize that transactions are a logical subject for CAM consideration. A merger, acquisition or sale frequently involves the acquisition or loss of intangibles or a prediction about the effect of the transaction on the company’s financial statements, particularly when the transaction is outside of the normal course of business. For example, the audit report in one Form 10-K identifies a corporate acquisition as a CAM due to management estimates of the fair value of acquired customer relationships, an intangible asset. The high degree of management judgment led in turn to significant audit effort, auditor judgments, and the use of audit professionals with specialized skills.

6. Consider the relationship between CAMs and Critical Accounting Estimates

An SEC staff member has pointed out that there may be overlap between CAMs and critical accounting estimates (“CAEs”) and that some CAMs may raise issues about accounting estimates that will need to be considered when preparing disclosures about CAEs. Companies want to assess whether there is a connection between their CAMs and their CAEs. Recent filings have shown that CAMs may be based on management estimates that are not disclosed as CAEs by the companies. It is not axiomatic that every CAM regarding a management estimate will need to be disclosed as a CAE. This is likely to be an area on which companies and the SEC staff will focus.

Looking Ahead

Although the auditor is solely responsible for writing and communicating CAMs, a joint statement by the SEC Chairman, Chief Accountant and Director of the Division of Corporation Finance (the “Joint Statement”) encourages audit committees to engage with auditors to understand the nature of each CAM, the auditor’s basis for the determinations, and how each

26 Id.
CAM will be described in the auditor’s report. This advice is especially important given the fact that issues raised in CAMs routinely appear throughout companies’ disclosure documents. Perhaps expecting some growing pains as companies deal with their first CAMs disclosures, the Joint Statement “encourage[s] audit committees to continue their efforts to understand the new standard and remain engaged with auditors in the implementation process.”

Looking ahead, companies should:

- Remember that each CAM may be based on a variety of factors set forth in AS 3101. Management and audit committees will want to understand the factors which auditors must consider when identifying issues as CAMs, such as significant estimates or judgment, and discuss those with auditors early in the audit process.
- Conduct dry runs with the auditor to gain familiarity with the CAM process, the description of a CAM, and with the auditor’s basis for the determination of a CAM.
- Consider, in preparing annual reports, that CAMs involve issues that are likely to inform disclosure, internal control, and accounting policies and estimates, and that those connections are carefully considered in the preparation of the annual report.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Capital Markets and Securities practice:

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28 Id.
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