PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Interim Analysis Report

Evidence on the Initial Impact of Critical Audit Matter Requirements

PCAOB Release No. 2020-002
October 29, 2020

CONTENTS

INTRODUCTION

This report provides insights and the perspectives of the Public Company Accounting Oversight Board (PCAOB) on the initial impact of critical audit matter (CAM) requirements on key stakeholders in the audit process.

The CAM requirements took effect in June 2019 for audits of large accelerated filers (LAFs) and will become effective later this year for audits of all other companies to which the requirements apply. CAM communications are intended to inform investors and other financial statement users about matters that required especially challenging, subjective, or complex auditor judgment, and the auditor's response to those matters. Further information on the CAM requirements is available on the PCAOB's website.

The PCAOB is committed to understanding the impact of the CAM requirements. As a part of this commitment, the staff of the PCAOB's Office of Economic and Risk Analysis has performed several analyses to gain an initial understanding of:

- audit firm and audit engagement team responses to the CAM requirements,
- investor use of CAM communications, and
- audit committee and preparer experiences related to CAM implementation.

The staff has also evaluated whether early evidence from initial implementation of the CAM requirements is suggestive of significant costs, benefits, or unintended consequences.[1]

KEY FINDINGS FROM STAFF ANALYSES

- **Audit firms made significant investments to support initial implementation of the CAM requirements.** Firms developed tools and guidance, trained personnel, established networks of CAM subject matter experts, and established consultation and review protocols for draft CAM communications. In addition to investments made at the audit firm level, individual audit engagement teams spent (on average) about 1% of total audit hours identifying, developing, and communicating CAMs in the year of implementation. Extensive upfront preparations—including pilot and dry run programs—contributed to a generally smooth experience for issuers. Overall, the staff's analysis suggests that costs to LAFs related to auditor implementation of the CAM requirements were largely inconsequential.

- **Investor awareness of CAMs communicated in the auditor's report is still developing, but some investors are reading CAMs and find the information beneficial.** Among other things, investors are using CAMs to better understand the work of the auditor and company disclosures. Some investors have emphasized that they value CAMs that are specific and tailored to the audit, and others have encouraged auditors to expand CAM communications to provide information about the outcome of audit procedures.

[1] The staff is unable to evaluate all possible costs and benefits of the CAM requirements (e.g., because some potential effects may take more time to manifest or stabilize). In addition, the results presented in this report may not be predictive of the effect of the CAM requirements for audits of other companies to which the requirements will apply. In some cases, results are based on limited data and may not be generalizable to the entire stakeholder population. We encourage interested readers to review the staff white papers that provide additional results and technical details of the staff's analysis. Further discussion of economic considerations related to the CAM requirements is available in the PCAOB's Adopting Release.

- **The staff has not found evidence of significant unintended consequences from auditors' implementation of the CAM requirements for audits of LAFs in the initial year.** The PCAOB will continue to monitor and evaluate the impact of the CAM requirements, including any significant unintended consequences, as auditors begin to implement the CAM requirements for audits of other public companies.

RESULTS IN DETAIL

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

Audit Firm Survey

All U.S. audit firms with at least 15 LAF clients (eight firms in total, including the Big Four) completed a survey in June 2020 on the processes and procedures they developed to prepare for and implement the CAM requirements, including associated costs.

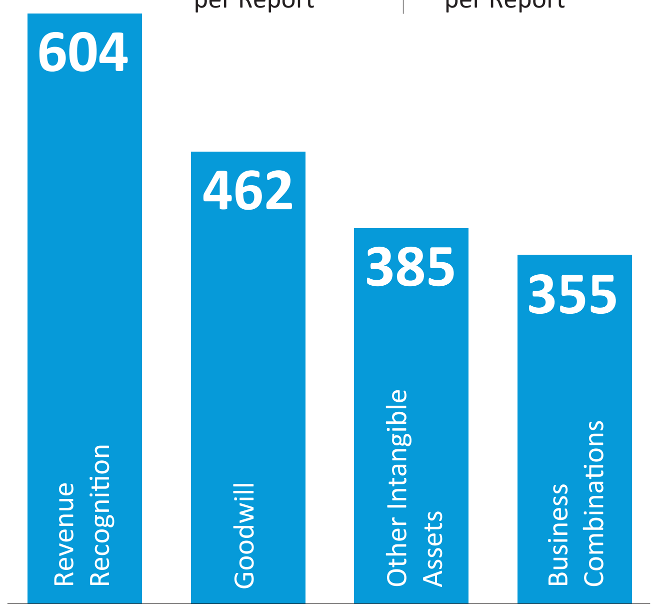
- Audit firms reported that they made significant upfront investments to support implementation of the CAM requirements, including conducting pilot and dry run programs, creating tools and guidance, training their personnel, establishing networks of CAM subject matter experts, and developing consultation and review protocols for draft CAM communications.

- Big Four firms provided estimates indicating that, on average, through April 2020, these firms spent around 23,000 hours developing processes and procedures to support CAM implementation (53% at the partner level) and 14,600 hours for the firm's personnel to attend CAM-related training (32% at the partner level). The remaining four firms that participated in the survey estimated that they spent, on average, about 3,700 hours developing processes and procedures to support CAM implementation (41% at the partner level) and 3,100 hours for the firm's personnel to attend CAM-related training

2,420 Reports Containing CAM Communications

1.7 Average Number of CAMs Communicated per Report

0 - 7 Range of Number of CAMs Communicated per Report



Most Frequently Communicated CAMs

Audit reports filed as of October 8, 2020, for issuers with fiscal year ends ranging between June 30, 2019 and June 29, 2020
Sources: SEC's EDGAR system and PCAOB Office of Economic and Risk Analysis

(30% at the partner level).[2] PCAOB staff estimate that, on average, these hours correspond to approximately $6.5 million and $1 million of implementation costs for each Big Four firm and each of the remaining four firms, respectively.[3]

- Differences in time spent developing processes and procedures to support CAM implementation and training firm personnel reflect differences in underlying audit client portfolios. Big Four firms have an average of 465 LAF clients and 323 non-LAF clients, and the other four firms that participated in the survey have an average of 39 LAF clients and 142 non-LAF clients.[4]

Engagement Partner Survey

The staff fielded a voluntary survey in May/June 2020 of engagement partners at the eight audit firms that participated in the firm survey. The survey asked for information about the experiences of engagement partners in implementing the CAM requirements. The staff received 902 complete responses to the survey.

- Engagement partners reported that, on average, about 1% of total audit hours were spent identifying, developing, and communicating CAMs. Approximately two-thirds of this time was spent prior to the issuer's fiscal year-end.
- During the rulemaking process that resulted in the adoption of the CAM requirements, some commenters suggested that CAMs would inhibit communication among auditors, preparers, and audit committees because of concerns about what would be publicly communicated in the auditor's report. Less than 2% of engagement partners who participated in the survey reported that the CAM requirements constrained auditor communications with the audit committee, while 41% reported that the CAM requirements enhanced these communications.
- More than one-third of engagement partners (39%) reported that the issuer made changes to financial statement disclosures or other corporate reporting because of CAMs.[5] Additionally, a small number of engagement partners (2%) reported that the issuer made changes to internal controls over financial reporting because of CAMs.
- During the rulemaking process, some commenters expressed concern that CAM communications could cause auditors to spend additional time and resources on audit areas related to CAMs. Only a small number of engagement partners (3%) reported making changes to the nature,

[2] Some firms used specific charge codes to track firm-level hours supporting CAM implementation, while others estimated hours by listing the activities involved and having project personnel estimate the level of effort for each. To estimate the number of hours spent on training, firms generally identified specific courses or portions of courses that focused on CAMs and multiplied the length of the CAM-related content by the number of participants enrolled. Firms reported hours specifically associated with CAM implementation, excluding hours related to other new requirements such as auditor tenure disclosure.

[3] Estimates are calculated by multiplying total hours spent by partners and other firm personnel by estimated hourly compensation rates. See staff white paper "Stakeholder Outreach on the Initial Implementation of CAM Requirements" for further details of these calculations.

[4] The average number of clients is estimated using data from public company audits conducted from 2017 to 2019. The staff will further study the costs of the CAM requirements to firms of different sizes as part of a later post-implementation review.

[5] The staff's engagement partner survey did not ask respondents to elaborate on the nature of any changes to company disclosures; however, in general, preparers did not report making significant changes to company disclosures because of CAMs. The staff will further explore the impact of CAMs on company disclosures as part of a later post-implementation review.

timing, or extent of audit procedures because of requirements to communicate CAMs.

- In response to an open-ended question, 139 engagement partners (15%) provided additional input on the impact of CAMs. About half of these partners asserted that the information presented in CAMs provides little value to investors or financial statement users (67). Others said that there were significant administrative burdens associated with the CAM communication process (26) or that CAM implementation required large amounts of documentation (8). Some engagement partners said that they felt pressure to identify at least one CAM, even though they did not believe that any individual matter met the definition of a CAM (19). Others reported that audit committees expressed a strong preference that their CAMs were similar to other issuers in the same industry (7).

Investor Survey

The staff fielded an investor survey in April/May 2020 to gather information about investor awareness, perceptions, and use of CAM communications. The staff received 97 complete responses from investors who (1) research investments for their personal accounts and/or as part of their job, (2) research individual companies, and (3) conduct fundamental or governance analysis of companies.

- Investor awareness regarding CAMs is still developing. A majority of investors who completed our survey had heard of CAMs (63%), although less than a third had seen CAMs in an audit report (31%).
- Among other things, investors reported using CAMs to better understand the work of the auditor, better understand financial statement disclosures, and develop questions for company management.
- Investors who had seen CAMs were asked about their perceptions of the CAMs they had seen. Investors who had not seen CAMs were shown two randomly-chosen representative examples of actual CAMs included in audit reports and then asked questions about their perceptions of those CAMs. Overall, most survey respondents viewed CAMs as at least somewhat tailored to the audit (72%) and easy to understand (55%). Participants also reported that they were likely to use CAMs in the future (e.g., 66% reported that they were likely to use CAMs to identify risks associated with a given company).
- Investors who had seen CAMs were given an open-ended prompt asking them to share two reasons why they would or would not use CAMs in the future. Of 21 responses, eight said they would use CAMs in the future, four said they might use CAMs in the future, and nine said they would not use CAMs in the future. Of those who said they would use CAMs, a common theme was that CAMs helped to highlight areas that were particularly subjective or more difficult to audit. Among those who said they would not use CAMs, participants said that CAMs are not specific enough to provide useful information or do not provide additional value above and beyond what is already included in financial statements.

Audit Committee Chair and Preparer Interviews

Between September 2019 and February 2020, the staff conducted in-depth interviews of 12 audit committee chairs and 10 financial statement preparers (whose titles included Chief Financial Officer, Chief Accounting Officer, and Controller) of the 12 LAFs with

June 30 year-ends that were selected for 2019 CAM inspection procedures (see *Critical Audit Matters Spotlight*). The interviews provided insight regarding issuer experiences with initial CAM implementation.

- Significant upfront preparation by auditors (including dry run programs) contributed to a generally smooth experience for issuers. Audit committee chairs and preparers who participated in a dry run considered it useful in preparing for their auditor's implementation of the CAM requirements and understanding what to expect.
- Concerns expressed by some preparers and audit committee chairs about CAMs during the rulemaking process do not appear to have manifested in practice. In particular, none of the audit committee chairs interviewed said that CAMs had "chilled" or negatively impacted communications with their auditors, and none of the interviewees expressed concerns regarding the disclosure by the auditor of information about the company that had not previously been made publicly available.
- Several preparers said that they compared planned company disclosures to auditor's draft CAMs, although none reported making significant changes to company disclosures because of CAMs. Preparers also told the staff that CAMs have not driven significant changes to company financial reporting processes or controls.
- No participants had received direct investor feedback on CAMs, but some said that CAMs contain valuable information for investors.
- Although preparers reported some costs associated with their auditor's implementation of the CAM requirements (e.g., management time, increased audit fees), almost all said that such costs were inconsequential. One preparer said that, for the first time, their auditor involved a specialist in auditing a matter communicated as a CAM, and that the issuer was billed for this additional audit work.

Statistical Analysis of the Impacts of Initial CAM Implementation

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

- The staff's large-sample statistical analyses do not suggest, on average, an increase in engagement level costs (in terms of audit fees and audit hours) associated with initial CAM implementation. While individual engagement teams spent time implementing the CAM requirements, the staff's analysis suggests that, in general, auditors did not pass along the costs of CAM implementation to issuers in the initial year. Emerging academic research on CAMs also does not find a relationship between initial CAM implementation and audit fees.
- During the rulemaking process, some commenters expressed concern that, as a result of the additional effort required to determine, communicate, and document CAMs, auditors would take longer to issue their reports. The staff's large-sample statistical analyses do not suggest that, on average, initial CAM implementation is associated with an increase in the time to issue audit reports.
- Consistent with emerging academic research, PCAOB staff analyses of stock market data does not provide evidence that, on average, investors responded to the

information content in CAMs in the first year of implementation. The full benefits of CAM communications to investors may take more time to materialize (e.g., as investor awareness of CAMs becomes more widespread and as more data on CAMs becomes available across issuers and over time).

Public Request for Comment

The staff issued a public request for comment to provide all interested stakeholders the opportunity to provide information on initial experiences with CAM implementation. The staff received 23 comment letters from a variety of stakeholder groups including auditors, investors, financial statement preparers, and academics.

- Input from comment letters was generally consistent with findings from the PCAOB's other outreach and data analysis efforts. For example, comment letters did not identify significant unintended consequences from initial CAM implementation.
- Due to disruptions caused by COVID-19, one commenter suggested a one-year deferral to the CAMs effective date for audits of smaller issuers while allowing for early voluntary adoption. Other commenters noted that CAM communications are likely to take on increased importance during this period of uncertainty.

WHAT'S NEXT?

The CAM requirements will take effect for audits of fiscal years ending on or after December 15, 2020 for all companies to which the requirements apply. The requirements are already in effect for audits of LAFs.

The PCAOB expects to issue a further report in 2022 to provide perspectives on any changes the staff observes in the communication of CAMs and to provide insights on the initial impact of CAMs communicated in the audit reports of smaller issuers. Because some of the effects of the CAM requirements may take several years to fully manifest or stabilize, the PCAOB plans to perform and publish a more comprehensive post-implementation review in 2024.