Critical Audit Matters Significance
In the New Audit Report

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Abstract:

CAMs will draw the attention of the user looking at the auditor's report and ultimately make the related financial statement disclosures more salient That because users will view the CAM as a cue to guide and prompt them to attend to and read the relevant disclosure in greater detail. By highlighting some parts of the financial statements, CAMs play a signaling role that helps users reduce the cognitive load associated with identifying and attending to the relevant information when performing a financial statement analysis task. This paper shows the importance of CAMs in the new audit report and how it solves the problem of information as Asymmetry to the user of financial statement by analyzing the current literature review.

Key words:

Critical audit matter, Key audit matter, Information Asymmetry, PACOB, IAASB. Emphasis of matter, Other matters.

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In the New Audit Report

Section 1: Introduction

In 2009 the International Auditing and Assurance Standards Board (IAASB) initiated a project entitles 'Auditor reporting' with an objective to appropriately enhance the communicative value and relevance of the audit report. **(Boris & Anna 2018, p 241)**This act of the IAASB can be considered as a starting point in the revision of the International Standards on Auditing related to the structure and content of the audit report. After perennial consultations, dialogs, numerous comments received, on January 2015, the IAASB issued six revised and one new Standard related to the auditors reporting. Revised and new Standards become effective for audits of financial statements for periods ending on or after December 15, 2016. The most significant content change relates to the new Standard ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report. **(Boris & Anna 2018, p 241)**

The intention of including new paragraph(s) in the report, related to The key audit matters (KAMs)[5], was to enhance its communication value by providing greater transparency on performed audits, and to give insights to stakeholders to the matters that, in the auditor's professional judgment, were of the most significance. **(Boris & Anna 2018, p 241)**

The objective of this paper is to investigate the new element – **CAM/KAMs** and its significance on the user of financial statements. The paper organized as follows: ***Section 2*** address the need of new report with extended disclosures, *Section 3* address the Framework of CAMs of the new audit report model ,***Section 4*** address the debate about level of assurance provided on CAM and what is the main responsibility and liability of audit when CAMs disclosed in the audit report , *Section 5* address the Expected costs & Benefits from disclosing CAMs in the audit report , *Section 6* address The relationship between the CAM/KAM and EOM/OM and GC and ICOFR , *Section 7* address the significance of CAMs in the audit report for the financial statement users, *Section 8* address the paper conclusion.

[5] key audit matters (KAM) terminology under IAASB and also known as Critical Audit Matter (CAM) under PACOB

Section2: The Need of a new audit report with extended disclosures

The value of the current pass/fail version of the standardized audit report has been criticized as not providing stakeholders with much information beyond the qualified vs. unqualified opinion. **(Pelzer,2016,p6)**As this criticism goes as far back as a report from the Cohen Commission on Auditor's Responsibilities in 1978 which was one of the first to identify areas in which the report was lacking, including confusion over the auditor's role and what happens during an audit. Such confusion seems to have led to what is described by **expectations gap** in which users and auditors have differing views of the messages included in the audit report. Over the years, there have been attempts to close this gap.

A similar expectations gap has been documented internationally in China, Hong Kong, **Egypt**, Malaysia, and the U.K. **(Pelzer, 2016,p6)**There are studies which find that the additional information included in expanded audit reports such as those that contain going concern opinions and emphasis of matter paragraphs provide users value. Were those studies which suggest users would like the audit report to provide additional information outside of the pass/fail opinion and deficiency reporting due to the increased complexity of today's business environment to close the reporting expectations gap. **(Pelzer, 2016,p7)**.As such In of what stated above , In summary The deficiency of the Standardized audit report could be determine by the following reasons:

2.1 Information Asymmetry: (A. CODY, 2018, p273-274)

Information asymmetry exists between investors and corporate insiders, and by extension between investors and auditors. This aspect of the Information asymmetry problem deals with the availability of information. This "public-private divide" defines the struggle in determining how much information should remain available only to insiders and how much should be available to outsiders (i.e., the public). Economically, this is undesirable because markets should operate with perfect information. Mandatory disclosure reduces the cost of searching for information by making it publicly available.

However, there is another information asymmetry divide between institutional and individual investors created because institutional investors are better able to process the available information and use it in decision making. Individual investors lack the ability to "process and contextualize . . . information," which creates further information asymmetry between these parties. Even if individual investors had the ability to process this information, it would take

them a significant amount of time and resources to do so, widening the divide between individual and institutional investors in being able to react in the market based on the information.
The remedy for information asymmetry is introducing more information that requiring companies to disclose more information to the public. Disclosure is positively correlated with world economic events.
Nevertheless, too much information increases the risk of information overload and creates an environment for worse decision making in which investors have to "satisfied" instead of utilizing all the information available to them.

2.2 Information Overload: (A. CODY, 2018, p275-276)

Overcorrection of information asymmetry leads to information overload. Information overload is the "point where there is so much information that it is no longer possible effectively to use it." At this point, investors "satisfied" and use a few attributes to draw comparisons among the Available options for investment, often leaving much out of their analysis.
Due to the limitations on the human ability to process information, information overload limits the effectiveness of disclosure. Overload is not caused by an individual disclosure, but by the "accumulation" of disclosures, as investors must choose which disclosures to focus on.
The information overload problem supports the need for specifically-targeted required disclosures, rather than relying on the assumption that "more is better."
The point where information is no longer usable is different for individual and institutional investors. Institutional investors have more resources to process and analyze all the information disclosed, and perform pattern and trend analysis among industries that individual investors would not be able to do as easily or as quickly. In other words, This divide is also characterized by a cost issue — i.e., the cost associated with analyzing the overwhelming amount of information available— as it may not be worth the time and money investment for the individual investor considering how much they have invested in the market.

However, for the institutional investor, analyzing data may be worth the time and money investment due to the large amount of money in play and the economies of scale created by the standardization of the analytical process. By focusing on individual investors, securities laws can help close this time and cost divide.

2.3 Characteristics of Effective Disclosure (A. CODY, 2018, p275-276)

Disclosure can confuse investors. Numerous scholars studied the characteristics of effective disclosure, considering the need to counteract bias and the limitations on the human ability to process information.

There are characteristics that must be considered as a whole in order to determine AS 3101'[6]s usability and effectiveness which are:

First, ***length;*** this plays a critical role in investor's ability to understand and analyze the information given as investors may miss important information if the disclosure is too long. **Second,** *completeness*; the disclosure must contain sufficient information, including "meaningful detail," for the reader to be able to interpret the disclosure correctly and be confident that relevant information is not missing. **Third,** *"accumulation"*; in designing the disclosure, regulators must consider that it is not only the individual disclosure but all the disclosures provided that investors consider in choosing how to spent their time. ***Finally,*** standardization; standardization of disclosures promotes consistency, which makes it easier for investors to evaluate them and compare among companies. ***Standardization of "content, format, and timing"*** such as Through the use of charts, graphs or tables, while promoting comparison among companies, prevents companies from opportunistically selecting the way in which their information is presented. ***The "critical audit matter" requirement of the Independent Auditor's Report has all these characteristics, and on its own would constitute an effective disclosure.***

Section 3: Critical audit matter Framework in the new audit report model

3.1 Definition of Critical Audit Matter:

Under the American audit standard (AS 3101) a **Critical audit matter "CAM"** 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

[6] The Public Company Accounting Oversight Board (PCAOB) enacted a new auditor reporting standard on June 1, 2017. The new standard is entitled: "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion" (AS 3101).

involved especially challenging, subjective, or complex auditor judgment. **(PCAOB Release No. 2017-001, p16)**

On the other hand, the International auditing standards " **ISA 701**" define the **Key Audit matter "KAM"** 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. Key audit matters are selected from matters communicated with those charged with governance. **(IAASB, 2015b, p3)**

3.2. Criteria of determining the matter is CAM or Not:

3.2.1 Criteria of determining the matter under PACOB:

(PCAOB Release No. 2017-001, p16-21) Under the American audit standard **(AS 3101)** determine three main conditions to consider the **matter is CAM or Not as follows:**

3.2.1.1 Communicated or required to be communicated to the Audit Committee:

PACOB stated that matters communicated to the audit committee are the most meaningful to users of the financial statements and using them as the source of critical audit matters would assist the auditor in determining critical audit matters in the most efficient and effective manner.

PCAOB standards require the auditor to communicate to the audit committee, among other things:

- Significant risks identified by the auditor;
- Certain matters regarding the company's accounting policies, practices, and estimates significant measurement uncertainty.
- Significant unusual transactions;
- Certain matters regarding the auditor's evaluation of the company's
- relationships and transactions with related parties; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

3.2.1.2 Relates to Accounts or Disclosures That Are Material to the Financial Statements:

PACOB has determined to adopt the materiality component in the final definition of critical audit matter as reproposed[7]. In the Board's view, the purpose of the standard—making the auditor's report more useful and Informative to investors—is better served by auditor communication of matters related to accounts or

[7] *The Reproposal of PACOB 2016*

disclosures that are material to the financial statements. As one commenter noted, limiting the source of critical audit matters and adding a materiality component that directly relates to accounts and disclosures "would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of [critical audit matters] within the auditor's report that could deemphasize their importance.

At the same time, in the Board's view, limiting critical audit matters to those that are, in and of themselves, material to the financial statements as a whole would not serve the intended purpose of the standard. If the auditor were required to determine that a critical audit matter itself is material, rather than related to an account or disclosure that is material, it is likely that fewer matters would meet the definition of a critical audit matter and, thus, investors would likely receive less, and less audit-specific, information than under the standard as adopted.

Accordingly, as in the Reproposal, the final standard provides that each critical audit matter relates to accounts or disclosures that are material to the financial statements. Consistent with the Reproposal, "relates to" clarifies that the critical audit matter could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. **For example**, the auditor's evaluation of the company's goodwill impairment assessment could be a critical audit matter if goodwill was material to the financial statements, even if there was no impairment; it would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company's impairment policy and goodwill. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. **For example,** the auditor's evaluation of the company's ability to continue as a going concern could also represent a critical audit matter depending on the circumstances of a particular audit.

On the other hand, a matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter. **For example,** a potential loss contingency that was communicated to the audit committee, but that was determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a critical audit matter; it does not relate to an account or disclosure in the financial statements, even if it involved especially challenging auditor judgment. The same rationale would apply to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements; the matter Would not relate to an account or disclosure that is material to the financial statements.

For the same reason, the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, cannot be a critical audit matter; such determination, in and of itself, does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. A significant deficiency could, however, be among the principal considerations that led the auditor to determine that a matter is a critical audit matter.

3.2.1.3 Involved Especially Challenging, Subjective, or Complex Auditor Judgment:

After consideration of comments, the Board is adopting this component of the definition of critical audit matter as Reproposed, namely "matters that involved especially challenging, subjective, or complex auditor judgment." This ground the definition in the auditor's expertise and judgment, which is directly responsive to investor requests for information from the auditor's point of view. Thus, the Board believes that this definition will focus critical audit matters in areas where investors will particularly benefit from expanded reporting by the auditor.

The determination of critical audit matters is principles-based and the final standard does not specify any items that would always constitute critical audit matters. **For example,** the standard does not provide that all matters determined to be "significant risks" under PCAOB standards would be critical audit matters. Some significant risks may be determined to be critical audit matters, but not every significant risk would involve especially challenging, subjective, or complex auditor judgment. **To illustrate,** improper revenue recognition is a presumed fraud risk and all fraud risks are significant risks **however,** if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it will not be a critical audit matter. Similarly, the final standard does not provide, as some commenter's suggested, that material related party transactions or matters involving the application of Significant judgment or estimation by management always constitutes critical audit matters. The auditor must determine, in the context of the specific audit, that a matter involved especially challenging, subjective, or complex auditor judgment. In addition, focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. To the extent that critical audit Matters reflect differences in auditors' experience and competence; this in itself should also be informative.

3.2.2 Criteria of determining the matter under IAASB:

(PCAOB Release No. 2017-001, p26-27): Under the IAASB's standard, "**key audit matters**" 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. Key audit matters are determined using a two-step process.

First, the auditor identifies the matters communicated with those charged with governance that required significant auditor attention in performing the audit, taking into account:

- Areas of higher assessed risks of material misstatement, or significant risks.
- 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.
- The effect on the audit of significant events or transactions that occurred during the period

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters. The IAASB requires the communication of key audit matters for the current period only.

3.3 Factors of identifying Critical audit matter:

(PCAOB Release No. 2017-001, p24-25): Under the final standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts or disclosures that are material to the company's financial statements, the auditor should take into account the following nonexclusive list of factors, as well as other audit-specific factors, 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.

3.4 Audit Period Covered by Critical Audit Matters: (PCAOB Release No. 2017-001, p25-26):

The final standard retains the requirement to communicate critical audit matters only for the current audit period. While most companies' financial statements are presented on a comparative basis, and thus most auditors' reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented, will provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users will be able to look at prior years' filings to analyze critical audit matters over time. However, the auditor could choose to include critical audit matters for prior periods. The final standard clarifies that the two situations relating to a prior period 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.

In situations in which a predecessor auditor has been asked to reissue its auditor's report, the communication of critical audit matters for the prior period need not be repeated because it is only required for the current year. However, the predecessor auditor could choose to include prior year critical audit matters in the reissued auditor's report.

3.5 Communicating & Reporting of the Critical audit matter:

3.5.1 Auditor responsibility for communicating CAM:

The **PCAOB AS 3101** standards required that, for each critical audit matter, the auditor would:

3.5.1.1 Identify the critical audit matter and describe the principal considerations that led the auditor to determine that the matter is a critical audit matter: (PCAOB Release No. 2017-001, p29): The Board[8] supported the identification of the critical audit matter and limiting the description to "*the principal considerations*" that led the auditor to determine that the matter is a critical audit matter. The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication will be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.

3.5.1.2 Describe how the critical audit matter to be addressed in the audit: (PCAOB Release No. 2017-001, p30) :The final standard includes the requirement for the auditor to describe how the critical audit matter was addressed in the audit because it is consistent with the Board's objective of providing more information about the audit and, if developed with an appropriate focus on the intended audience, should be of interest to users.

However the final standard does not prescribe a specific way to meet this requirement but ***the standard provided four examples of potential approaches to such descriptions***[9]: *(1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of the procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements.* As a helpful guidance on how the requirement could be met.

While the description of how ***the critical audit matter was addressed in the audit will require judgment***, the auditor ***should bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company's financial statements that will be useful to investors***. A brief overview of the audit procedures performed is one of the alternatives for describing how the critical audit matter was addressed. If the auditor chooses to describe audit procedures, the descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, as the four examples should make clear, the objective is to provide a useful summary, not to detail every aspect of how the matter was

[8] Public Company Over Sight Board

[9] These elements are similar to the IAASB's elements described in paragraph A46 of ISA 701

addressed in the audit. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.

***3.5.1.3 Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter:* (PCAOB Release No. 2017-001, p32)**

The final standard clarifies that the auditor could refer to the relevant account or disclosure, rather than both, to avoid potential duplication. Also the final standard only requires the auditor to refer to the relevant financial statement accounts or disclosures that because when the auditor refers to relevant disclosures outside the financial statements ***when describing a critical audit matter it may incorrectly suggest that such information is audited or cause readers to misinterpret the auditor's role in relation to such information.***

3.5.2 Reporting of the Critical audit matter: (PCAOB Release No. 2017-001, p 28): The American standard provided **introductory language** to be included in the "Critical Audit Matters" section of the auditor's report indicating that critical audit matters did not alter the opinion on the financial statements and that the auditor was not providing a separate opinion on the critical audit matters. The required introductory language should state that: ***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.***

The following figure (1) summarize CAM framework

Determining and Communicating Critical Audit Matters ("CAMs")

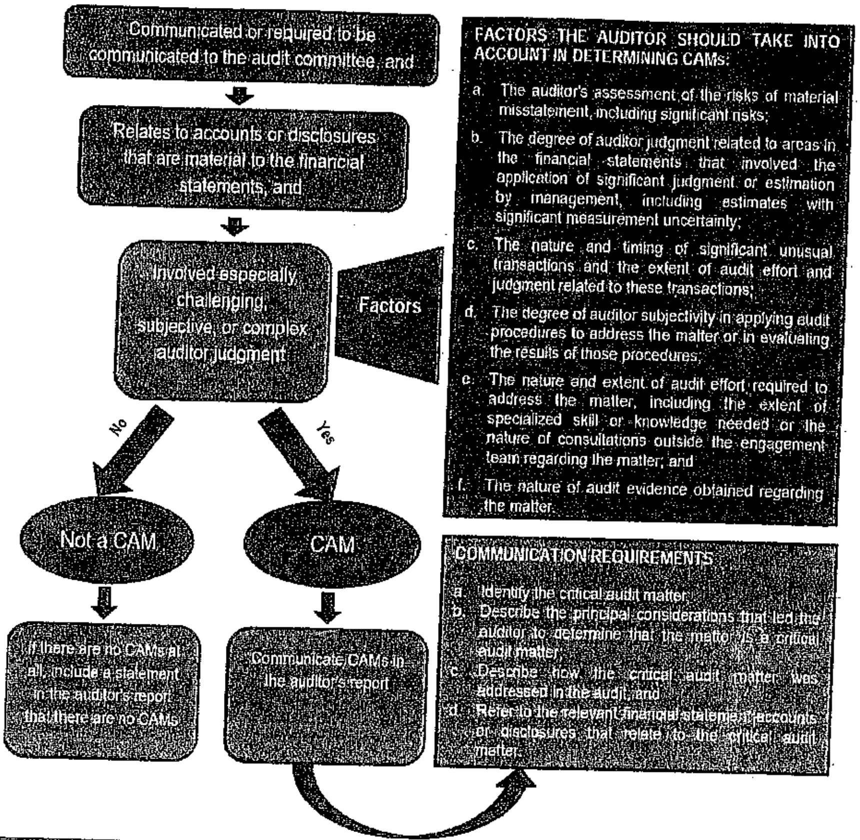

Figure (4) summarize CAM framework (PCAOB Release No. 2017-001, p 16)

Section 4: The debate on the level of assurance and auditor responsibility & liability when related CAM[10] disclosed

As CAM disclosures would provide more information about the audit to financial statement users, it is unclear how that information would influence user assessments of the level of audit assurance provided and the auditor's responsibility and liability for a

[10] *It Is CAM that related to certain material account or disclosure in the financial statement.*

subsequently revealed misstatement. **On one hand**, labeling a financial statement area as being "critical" to the audit connotes a sense of high importance to that area, potentially increasing the perceived level of assurance provided and fueling any counterfactual reasoning of what the auditor "should have Known" in the event that a material misstatement goes undetected by the auditor. **But on the other hand**, the PCAOB's definition of a CAM as involving "difficult, subjective, or complex judgments" could be taken to imply a partial qualification of the auditor's ability to reach definitive conclusions, thereby lowering perceived assurance in the CAM area and lessening the auditor's perceived responsibility and liability if a misstatement later arises in that area. **(Kachelmeer, Schmidt, Valentine2014,p30)**
A potential implication for practice is that the PCAOB's proposed standard could prompt auditors to issue laborious reports that disclose many CAMs, "covering all bases" to avoid the criticism of insufficient warning in the event that a misstatement is later discovered in an area that is difficult to audit. The PCAOB's proposal is explicit in cautioning auditors against CAM wording "that could be Viewed as disclaiming, qualifying, restricting or minimizing the auditor's responsibility for the CAM." Yet, our results suggest that the PCAOB's own definition of a CAM and suggested disclosure wording could have such an unintended effect. **(Kachelmeer,Schmidt,Valentine,2014,p31)** While financial statement users could potentially benefit from information about CAMs, concerns have been raised that CAM disclosures could be misinterpreted to imply ***"piecemeal" assurance*, *meaning different levels of assurance in different areas of the financial statements*.** In turn, the perception of piecemeal assurance could imply different levels of perceived auditor responsibility If a material misstatement is discovered later. **(Kachelmeer,Schmidt,Valentine,p1)**
In principle, auditors provide the same reasonable assurance for CAM areas as they provide for other financial statement areas, tailoring the nature and extent of audit procedures to compensate for any increased difficulty and subjectivity. However, there is no guarantee that financial statement users will interpret CAM disclosures in a manner consistent with this reasoning. In particular, highlighting a financial statement area as being "critical" to the audit, especially with additional disclosure of the related audit procedures performed, could make that area appear to have more assurance than other areas of the audit. Such disclosures could also be perceived as elevating the auditor's responsibility for that financial statement area, potentially increasing the auditor's liability in the event that a material misstatement is subsequently

discovered in that area. In particular, CAM disclosures create the potential for counterfactual reasoning of what the auditor "should have known" about any misstatement, given the expanded attention directed to the CAM area.

While audit firms are concerned that any sense of a "piecemeal opinion" from the PCAOB's proposal could elevate the auditor's legal exposure in CAM areas, the opposite effect is also possible if users interpret CAM disclosures as disclaimers of responsibility. Along this line, the PCAOB warns auditors against describing CAMs with language ***"that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the CAM"***. Yet, the PCAOB's own definition of a CAM and suggested wording for CAM disclosures could provide the very language the Board cautions against. Specifically, describing a CAM in terms of "difficult, subjective, or complex auditor judgments" could lead users to interpret a CAM disclosure as a warning of the limitations associated with auditing an inherently difficult area, thus prompting lower perceived assurance and lower auditor responsibility if a misstatement is subsequently discovered in that area. **(Kachelmeer, Schmidt, Valentine, 2014,p2)**.

(Kachelmeer et.al 2014) findings present a consistent theme which is: CAM disclosures using the PCAOB's suggested wording decrease perceived assurance in the area disclosed as a CAM, thereby also lowering the auditor's perceived responsibility and liability for a material misstatement subsequently discovered in the CAM area. The likely explanation is that users perceive the CAM ***wording as a warning of the difficulty and subjectivity associated with the CAM***, thereby partially Indemnifying the auditor from responsibility for problems in that area. **(Kachelmeer, Schmidt, Valentine, 2014, p3)**.

Users perceive significantly lower assurance for a financial statement area identified as a CAM than when the auditor's report identifies a different area as a CAM or with no CAMs identified. For auditor responsibility and liability, users hold the auditor significantly less accountable when a misstatement aligns with a disclosed CAM than when the auditor identifies a different area as a CAM. The Post-experimental questionnaire of the study responses indicate that participants tend to believe that the auditor is more competent, more credible, and that the level of disclosure in the auditor's report is more sufficient when a disclosed CAM matches the area of a misstatement, as if the auditor has given due warning. ***At a minimum***, that identifying an area as a CAM does not appear to *increase* perceived auditor assurance or responsibility for a misstatement relative to our no-CAM **(Kachelmeer, Schmidt, Valentine, 2014,p4)**.

Also the study findings provide no evidence that disclosed audit procedures prompt counterfactual reasoning of what the auditor "should have known" about the CAM, given the procedures employed .users appear reluctant to discern different levels of audit assurance from disclosed audit procedures – perhaps due to unfamiliarity with what procedures the auditor *should* perform. In our setting, participants appear aware of the disclosed procedures (as is evidenced by their responses to a manipulation-check question), but this awareness does not impact their tendency to view a CAM disclosure as a partial disclaimer of auditor responsibility for the area identified as a CAM **(Kachelmeer, Schmidt, Valentine, 2014, p5).**

Overall, the study suggests the potential for unintended consequences from the PCAOB's CAM standard. For audit firms, study mentioned that CAM disclosures in the auditor's report can lead to less perceived auditor responsibility for a misstatement in the area identified as a CAM. For the PCAOB, the study findings are consistent with the PCAOB's concern about CAM language "that could be viewed as disclaiming, qualifying, restricting or minimizing the auditor's responsibility for the CAM". ***The irony in this finding is that we detect it using the PCAOB's own suggested wording for CAM disclosures.*** **(Kachelmeer, Schmidt, Valentine, 2014, p6)**

Section 5: The expected Benefits & Costs from disclosing in the audit report

PACOB stated that **"the potential benefits and costs"** of disclosing CAMs in the audit report are inherently difficult to quantify, therefore the Board's economic discussion is primarily qualitative in nature. Analyzing the potential economic impacts, including the costs and benefits disclosing CAM in the audit report is a key way to develop regulatory changes that are well-reasoned, with potential costs that are warranted in light of the expected benefits. The board believes that a high-quality qualitative analysis can allow for this type of evaluation, particularly in those cases where quantification is not feasible. **(US Official News, 2018, p11-12)**

The expected benefits and costs of CAM must be considered along with its dual nature. On the one hand CAM may be viewed as pure supplementary information in the audit report. This conception leads to appreciate its benefits through its informative content; But On the other hand, the disclosure of CAM can be viewed as a new procedure imposed to auditors. This latter conception leads to appreciate its benefits and costs in terms of audit quality, cost or/and efficiency **(Bedard, Besacier, Schatt, 2014, p8)**. ***So the expected benefits and costs from disclosing CAM in the audit report could be sum up in the following points:***

5.1 Reducing information asymmetry:

The information asymmetry is reduced between auditors and users of annual reports when CAMs are disclosed. In this case, CAMs could be an appropriate solution to the information needs of users. Insofar as the CAMs can provide new information to users of annual reports, as such this may lead the financial market reacts to their disclosure. **(Bedard, Besacier, Schatt, 2014, p9)**

5.2 CAM and audit quality:

CAM may induce auditors to gather more and better audit evidence regarding the CAMs related items, thereby increasing audit quality. In addition, such accountability could result in an increase in the auditor's professional skepticism, another driver of audit quality.**(Bedard, Besacier, Schatt, 2015, p14)**

CAMs in the audit report could results in better quality audit. Disclosing that some key elements were analyzed may make auditors feel more accountable for matters to be reported, leading them to make additional efforts to analyze these elements. Some investors believe in such a positive effect. **(Bedard, Besacier, Schatt, 2014, p8)**

So Reading the CAM disclosures in the auditor's report may increase investors' confidence that the auditors identified and appropriately addressed the highest risk assertions in the financial statements. Increased confidence that the auditors performed their work diligently should increase investor confidence that the financial statements are stated fairly, which should lower the client's cost of capital. **(Clikeman, 2018, p13)**

5.3 CAM and Financial reporting quality:

A potential secondary benefit of disclosing CAMs is that auditors and audit committees may focus more closely on these high-risk accounts and transactions, resulting in higher quality audits. In addition, managers might improve the quality of their financial statement disclosures because they know investors will be scrutinizing more closely the matters identified as CAMs. **(Clikeman, 2018, p13)**

5.4 CAMs and audit fees:

KAMs should require additional audit effort by the most senior members of the engagement team for the determination, preparation, documentation, and reviewing of the KAM section of the audit report. In addition, even if the standard does not require additional audit procedures, auditors may feel more accountable for matters to be reported (e.g., gathering more and better evidence to audit these items). These costs are related to the increase of reputational risk and litigation risk, which are two key drivers of audit effort. **(Bedard, Besacier, Schatt, 2015, p12)**

On the other hand, some stakeholders argue that the disclosure of KAMs is a formal exercise that does not really affect the overall effort made by the auditor. Many respondents to the IAASB invitation to comment believe this because KAMs are related to information already addressed in the audit file and communicated to the audit committee. Thus, the main additional audit effort required is limited to determining, preparing the language for communication, and documenting the KAMs. Consequently, the auditor's incremental efforts and cost to report KAMs would be minimal. Moreover, auditors may not charge these additional reporting hours because of client reluctance to pay for such disclosure. **(Bedard, Besacier, Schatt, 2015, p12)**

5.5 CAMs audit report lag:

KAMs require effort to determine, prepare the language for communication, and document, KAMs. They may also result in additional audit effort because of accountability and liability effects. Audit report lag being significantly longer for engagements where more audit effort is needed. the inclusion of KAMs may result in a longer audit delay. Indeed, the PCAOB indicates that the drafting of KAMs, including the discussion among management, the auditor, and the audit committee regarding their nature and extent, could increase the time to complete the audit and issue the audit report. **(Bedard, Besacier, Schatt, 2015, p13)**

Auditors' response to this additional work may be to reduce the effort on other elements (review and completion of the audit work), add more resources, or surely delay the issuance of the audit report. In addition, discussion of the form and content of CAMs with management and audit committees prior to issuing the auditor's report may also delay the issuance of the auditor report. Indeed, the IAASB indicates that the more iterative process to finalize the auditor's report may affect the timing of release of the financial statements and the auditor's report. **(Bedard, Besacier, Schatt, 2014, p10).**

Section 6: The relationship between the CAM/KAM and EOM/OM and GC and ICOFR [11]:

Under IAASB Emphasis of Matter (EOM) and Other Matter (OM) paragraphs are required in certain circumstances and are otherwise permitted at the auditor's discretion. If ISA 701 applies, a matter may only be communicated as an EOM or OM if it has not been determined to be a KAM. However, in circumstances when an EOM or OM paragraph is required by the ISAs and the matter is also a KAM, it is communicated in both sections. When there is a material uncertainty related to going concern, although the matter is by its nature a KAM, it is not included in the KAM section of the auditor's report and the requirements relating to the description of KAM do not apply. ***(IAASB, 2017, p7)***

The application material in ISA 701 notes that the severity of any control deficiencies related to a matter is a factor that could be considered by the auditor in determining the relative significance of a matter communicated with those charged with governance, and whether the matter is a KAM

PACOB standards permit the inclusion of emphasis paragraphs, although no requirement exists; however, these paragraphs may not serve as a substitute for CAM. There is a continued requirement to include explanatory language (or an explanatory paragraph) in certain circumstances. AM are not a substitute for required explanatory paragraphs. However, there could be situations in which a matter meets the definition of a CAM and also requires an explanatory paragraph, such as going concern. In these situations, both the explanatory paragraph and CAM would be required. The auditor may however include the description of the matter in both the explanatory paragraph and the CAM section with a cross-reference between them, or may include the required communication in the explanatory paragraph with a cross-reference in the CAM section to the explanatory paragraph. ***(IAASB, 2017, p7)***

The PCAOB has clarified that a significant deficiency in internal control over financial reporting, in and of itself, cannot

[11] *Emphasis on Matter/Other Matter/Going concern/Internal Control Over Financial Reporting*

be a CAM since such determination does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. Nevertheless, the PCAOB notes that a significant deficiency in internal control could be among the principal considerations that lead the auditor to determine that a matter is a CAM. ***(IAASB, 2017, p7)***

Section 7: Critical Audit Matters Significance in the New Audit Report:

CAMs will draw the attention of the user looking at the auditor's report and ultimately make the related financial statement disclosures more salient. On the one hand, users will view the CAM as a cue to guide and prompt them to attend to and read the relevant disclosure in greater detail. By highlighting some parts of the financial statements, CAMs play a signaling role that helps users reduce the cognitive load associated with identifying and attending to the relevant information when performing a financial statement analysis task. Accordingly, when a financial statement disclosure is referred to in the auditor's report as a CAM, it is expected that users will access the related disclosure (i.e., CAM-related) more rapidly and pay greater attention to it. **(Bedrad,Bera,2018,p143)**

As managers face a number of offsetting incentives when deciding what level of financial disclosure to provide. On one hand, managers are encouraged to disclose by concerns over their reputation, litigation risk and the firm's cost of capital. On the other hand, managers are discouraged from disclosure to avoid proprietary costs and to maximize their own compensation under stock price- sensitive compensation plans. In addition, management disclosure choice is sensitive to how informed managers believe investors are about whether management possesses private information about the firm's risks and prospects. If investors are thought to know less (more) about management's possession of private information, management would be expected to provide less (more) voluntary disclosure of bad news. **(Fuller,2015,p13)**

An auditor's decision to report a matter as a CAM effectively shines a spotlight on the issue. As a result, managers are more likely to perceive a higher level of investor attention to and knowledge about the issue. Management would thus be more likely to increase the level of Disclosure for the subject of the CAM due to a shift in its incentives. Management would derive less benefit from lack of disclosure because they would expect investors to "fill in the blanks." In addition, if the matter was

spotlighted by the auditor, management's concern would shift to its reputation and litigation risk, both of which call for increased disclosure. Furthermore, if the auditor's reporting on the CAM was more expansive and included a detailed discussion of *why* the auditor was emphasizing the matter, the perceived level of investor knowledge would be even higher and should lead to even greater level of disclosure provided by management. **(Fuller,2015,p14)**
As CAM disclosure highlights the inherent complexity in the related account, and this complexity is impact investors' perceptions of management's influence on financial reporting quality. In contrast, CAM disclosure to positively impact investors' perceptions of the auditor's influence on financial reporting quality. By disclosing a CAM, auditors inform users of an account that carries heightened risk of misstatement, explain why they consider it a CAM, and describe the audit work performed to address it. This salient warning and description of additional effort should positively impact perceptions of the auditor's influence on financial reporting quality. **(Rapley,Ropbertson,Smith,2018,p4)**
Because of accounting areas possess high risks like fair value estimates that often pose a high degree of subjectivity and can have large reasonable ranges that pose unique difficulties to auditors, drawing investor attention to such information should make investors more wary of investing. Investors perception influenced by a CAM paragraph centered on the audit of fair value estimates. This because of the ***informative value enhancement effect*** that derived from footnote disclosure combined with a CAM paragraph in the audit report is compared to footnote disclosure alone. In addition to a ***source credibility effect*** for the information in the CAM paragraph as the auditor's task is to independently opine on the financial statements, whereas management is incentivized to cast themselves in a positive light and thus, the CAM paragraph is higher than that of management-generated footnote disclosures. **(Christensen, Glover, Wolfe, 2014,p7).**
It should be mentioned that, it is expected that investors' assessments of management's reporting credibility will decrease when the matter discussed by CAMs is governed by a precise accounting standard **(i.e., the relative amount of implementation guidance**). Alternatively, the lack of accounting standard implementation guidance may increase the perceived financial statement risks. Since investors would already anticipate those risks, the information presented by CAMs would be congruent with their existing expectations, and CAMs would not further influence their perceptions. **(Ozlanski, 2019,p2)**

As an example explaining the relation between accounting matter disclosed as a CAM and the degree of standards precision on the investors' assessments of management's reporting credibility , is the **fair value measurements** and disclosure of risks related to point-estimates*(precise)*,via CAMs, is inconsistent with investors' existing perceptions of financial statements because point-estimates imply a higher level of precision and, thus, less underlying risk associated with the estimated amount ,which will decrease the investors' assessments of management's reporting credibility. In contrast the disclosure of risks related ranges over point-estimates ***(imprecise)***, via CAMs is consistent with investors' existing perceptions of financial statements because range-estimates imply a lower level of precision and, which will not add or influence the investors' assessments of management's reporting credibility **(Ozlanski,2019,p4).**

Within the financial reporting context, audit committee (AC) members are entrusted with the responsibility of protecting shareholder interests and overseeing the external audit process. Thus, normatively speaking, investor protection should be a salient motive underlying AC members' behavior. In addition, AC members arguably self-select into their fiduciary role because they desire to help protect others with integrity. **(Kang, 2019,p3)**

In the AC context, there has been a recent change in the audit environment that will likely impact the extent to which investor sophistication affects AC members "questioning behavior" the new auditor reporting standard, AS 3101. The new standard makes various changes to the existing auditor's report, including a requirement to communicate CAMs. As CAMs are defined as matters communicated or required to be communicated to the AC and that (1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment. The fact that CAMs will be drawn from "matters required to be communicated to the AC (even if not actually communicated) and matters actually communicated (even if not required) to the AC and that disclosure of CAMs are intended to increase AC's focus on Such matters, suggests AC members will play an important role in the process of identifying and communicating CAMs to investors. **(Kang, 2019,p3).**

Management is accountable to the audit committee for its reporting choices. As part of their duties, audit committees communicate with both management and auditors and review the company's financial statements, disclosures and audit report in order to perform their financial reporting oversight. Since management has incentives to avoid disclosure, one purpose for the audit

committee's oversight of financial reporting is to constrain management's opportunistic disclosure decisions. To the extent that an auditor's reporting of a critical accounting estimate as a CAM increases the scrutiny of management's disclosure decision by the audit committee, the auditor's reporting on the CAM is also inconsistent with management's preference. **(Fuller,2015,p15).**
Accordingly, managers facing stronger audit committee oversight should be expected to process more deeply and be more influenced in their disclosure decision by the content of reporting on the CAM than managers facing only moderate audit committee oversight. **(Fuller,2015,p16).**

Section 8: Conclusion

The value of the current pass/fail version of the standardized audit report has been criticized as not providing stakeholders with much information beyond the qualified vs. unqualified opinion. The main reason of shifting the new expanded audit report is the Information asymmetry exists between investors and corporate insiders, and by extension between investors and auditors. This aspect of the Information asymmetry problem deals with the availability of information. As a response to the users need for more relevant information, there was a great development in the audit report since 2009 internationally when IAASB unleashed "Clarity Project that requires revising all current audit standards to improve clarity and quality. Subsequently The PCAOB issued Concept Release 2011-003 (Docket Matter No. 34) on possible revisions to PCAOB standards related to reports on audited financial statements and related amendments to PCAOB standards. They received 155 comment letters on the Release. Those previous development result to an important revolution in the audit reporting which is the critical audit matter that 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.

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