

# **Starbucks: Identifying & Writing Up a Critical Audit Matter (While Contemplating the Starbucks Experience)**

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## **Abstract**

The Starbucks case provides a hands-on learning experience for both undergraduate and graduate auditing students to apply the recently adopted Audit Standard 3101 (AS 3101) which, among other things, requires auditors to disclose critical audit matters (CAMs) in the auditor's report. The student is exposed to realistic facts and circumstances found in accounting practice, including the challenge of applying the new audit standard to the client's test for goodwill impairment. The case is structured to guide students through the critical thinking process of identifying, analyzing and evaluating factors that lead an auditor to determine an issue is a CAM. In addition to CAMs, the case also provides an opportunity to experience and discuss the recent changes to goodwill impairment testing set forth in Accounting Standard 2017-04. Finally, the case culminates with the student reviewing the SEC handbook on: How to Create Clear SEC Disclosure Documents with respect to the use of vertical lists and subtitles; and then writing up the CAM for inclusion in the auditor's report. The write-up requires the application of vertical lists and subtitles as well as providing the specific content required by AS 3101.

## **Introduction**

This case requires you to imagine that you have just arrived at work (early) to prep for a meeting with your audit manager. As a staff auditor, you are assigned to the 12/31/202x fiscal year-end audit of Starbucks. You know in advance that this morning you will be discussing the audit of the client's test for goodwill impairment. The case is divided into two parts. In Part I, you will research the requirements for recognizing a CAM and answer some related questions. Part I also requires you to research and answer questions relating to the recently updated guidance for goodwill impairment testing. In Part II, you will familiarize yourself with two of the SEC's suggestions for writing clear accounting disclosures; and then write up a CAM to be included in the auditor's report.

## **Part I**

### ***Client Background***

Starbucks sells specialty coffee with stores throughout the U.S. as well as the world. Starbucks common stock trades on the NASDAQ stock exchange under the symbol "SBUX." In addition to the Starbucks Coffee brand, they also promote the: Teavana, Seattle's Best Coffee, Evolution Fresh, Ethos, Starbucks Reserve and Princi brands. Specific popular menu items include an assortment of mochas, lattes, frappuccinos, cold brews, and teas.

The Starbucks stores are typically located in high-traffic, highly visible locations. The company tries to provide each customer with a unique ‘Starbucks Experience’. The Starbucks Experience consists of excellent service, convenience, and a seamless digital experience in safe, clean, and well-maintained stores. Each store is designed and operated to reflect the personality of the community in which it operates in an effort to encourage customer loyalty. In addition, they encourage more frequent store visits with the Starbucks Card, the Starbucks App, and the Starbucks Rewards loyalty program (where customers earn stars/credit toward future purchases).

Starbucks employs approximately 349,000 people. With respect to managing and investing in human resources/capital, the employee experience and the related work environment appear to be positive. For example, Glassdoor shows 35,000 Starbucks employee ratings averaging 3.9 vs the 3.3 out of 5 average for the Glassdoor community. Seventy-six percent of Starbucks employees would recommend their employer to a friend. In addition, among other benefits, two in particular that may be of interest to part time or student workers and/or a young work force demographic (as well as investors) is that they offer:

- Comprehensive health insurance coverage to employees working an average of only 20 hours or more each week.
- 100% tuition coverage to employees who earn a bachelor's degree online at Arizona State University through the Starbucks College Achievement Program.

For purposes of this case, we assume the following hypothetical facts, circumstances, and discussion with your audit manager.

#### ***Dialogue with Audit Manager***

The first thing on today’s agenda is a meeting with your audit manager. You (the auditor) arrived one hour early in order to give yourself time to prep for the meeting. Your audit manager scheduled a meeting with you to discuss the team’s audit of the Starbucks annual goodwill impairment test for each reporting unit. At 9:00 a.m. you arrive at the manager’s office.

**Manager** – Hi come in ... how are you? How was traffic this morning?

**Auditor** – I’m fine. Traffic was horrible as usual. Lots of construction and we caught every red light.

**Manager** - I’m preparing for a meeting with the Starbucks audit committee and one of the topics on the agenda is the Company’s annual assessment for goodwill impairment. Is my understanding correct that they recorded a goodwill impairment loss of \$350 million for the Eastern Reporting Unit?

**Auditor** – Yes, that’s correct. They recorded an impairment loss of \$350 million leaving a remaining balance for goodwill of \$6.5 billion.

**Manager** – How did the client test for goodwill impairment?

**Auditor** – They use a discounted cash flow (DCF) model under the income approach to estimate fair value. Each year (in the fourth quarter), management tests reporting units for goodwill impairment by comparing the estimated fair value of each reporting unit with its carrying amount.

**Manager** – Are there instances where they may test more frequently?

**Auditor** - Yes, a reporting unit may be tested more frequently if events or circumstances indicate it is *more likely than not* that the fair value of a reporting unit is less than its carrying amount. For example, among other things, an impairment test may be triggered by: a deterioration in general economic conditions, limitations on access to capital, changes in the market for an entity’s products, regulatory/political developments, a decline in financial performance, or the contemplation of bankruptcy/pending litigation.

**Manager** – Was there a recent accounting standard update from the Financial Accounting Standards Board (FASB) relating to testing for goodwill impairment?

**Auditor** – Yes. FASB, in Accounting Standard 2017-04 (issued Jan. 26, 2017), simplified the test by eliminating the calculation of the implied fair value of goodwill (aka: step 2). The goodwill impairment test now consists of one step comparing the fair value of a reporting unit with its carrying amount.

Consistent with the updated standard, the company recognizes a goodwill impairment loss if the carrying amount of a reporting unit, including goodwill, exceeds its fair value, limited to the total amount of goodwill allocated to that reporting unit. Where applicable, management also considers the income tax effect when measuring impairment loss.

**Manager** – Even after the update the test for impairment still sounds complicated?

**Auditor** – Yes, it is. Although it could be argued that the field of auditing is inherently challenging and complex, the impairment test for the Eastern Reporting Unit is *especially* challenging and complex because management's forecast of future cash flows relies on a significant degree of judgment, including estimates with significant measurement uncertainty. Specifically, management's estimates and assumptions related to forecasting future operating cash flows, including sales growth (volumes and pricing), operating costs, capital spending, discount rates and long-term growth rates.

In addition, a higher degree of auditor judgment and effort was required with respect to planning, implementing and reviewing the results of the related audit procedures. Finally, due to the complexity and specialized valuation skills required, we brought in a valuation specialist to assist us with planning and implementing the audit procedures. The specialist also assisted with the evaluation of audit evidence as well as the reasonableness of management's fair value calculation.

**Manager** – What audit standard and related requirements apply to our engagement of a specialist?

**Auditor** – Audit Standard 1210 (AS 1210), Using the Work of an Auditor-Engaged Specialist. AS 1210 includes the requirement to: assess the specialist's knowledge, skills, ability and objectivity; clearly establish and document the nature of the specialist's work to be performed; as well as supervise and evaluate the specialist's work.

**Manager** – How did we test the reasonableness of management's estimate of fair value?

**Auditor** – We started by testing the effectiveness of the internal controls relating to the annual goodwill impairment assessment, including the determination of reporting units. In addition, our procedures included evaluating the appropriateness of using a DCF model to calculate the fair value of goodwill, as well as the completeness, relevance, and accuracy of data inputs and related assumptions.

We performed sensitivity analyses on key assumptions (e.g., the discount rate, and growth rates for sales volumes and prices). In addition, we compared the data inputs and related assumptions (as well as the final results) for consistency with external market and industry data, including specific peer companies. We also tested the reasonableness of the final results (management's forecasted future cash flows) by considering the current and past performance of the operating unit, as well as for consistency with evidence obtained in other areas of the audit.

**Manager** – Do you think this is a critical audit matter?

**Auditor** – I'm not sure. As we previously acknowledged, it's material to the consolidated financial statements; and requires a relatively higher degree of judgment by both management and our firm. Plus, it's an audit matter to be communicated to the audit committee.

**Manager** – I think this is something we need to explore further. Research the PCAOB requirements for Critical Audit Matters and let me know if this is something that satisfies those requirements. I need this by tomorrow. Can you do it?

**Auditor** – Ok.

**Manager** – One last thing, if you think this satisfies the requirements, why don't you go ahead and prepare a draft of the critical audit matter as it would appear in the auditor's report. I suggest you read over the SEC Handbook on writing clear disclosures. Particularly where it discusses the use of subsection headings/bullets to break out/identify important information to assist the reader in processing complex topics.

**Auditor** – Sure, will do.

**Manager** – Thanks.

**Part I Case Requirements: Reviewing CAMs and Deciding Whether to Report**

The questions below should be completed before moving on to Part II. The questions can be answered based on the conversation above as well as by consulting applicable accounting and/or audit guidance.

1. Consult the guidance on what determines whether something should be reported as a CAM [see AS 3101.11]. What is the definition of a CAM?
2. List 6 factors [see AS 3101.12] that the auditor should take into consideration in determining that an audit matter involved: “especially challenging, subjective, or complex auditor judgment”.
3. What is a critical accounting estimate? Where are critical accounting estimates reported?
4. What is the difference between a CAM and a critical accounting estimate? As an auditor do you anticipate that every critical accounting estimate disclosed by management will also be identified by you as a CAM (reported in the audit report)?
5. Based on the conversation with the audit manager and your research, does management's test for goodwill impairment warrant being disclosed as a CAM in the audit report? Explain your answer.
6. How does the updated accounting standard (AS 2017-04, issued January 2017) simplify the test for goodwill impairment? Who is affected? As an auditor, how often would you expect management to test for goodwill impairment (as part of your answer look up and cite the applicable paragraph in AS 2017-04).  
Note: the required information to respond to this question is in the first 4 pages of AS 2017-04).

**Part 2 Case Requirements: Writing a CAM**

1. Consult Chapter 7 (Designing the Document) of the SEC handbook: *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*. Observe how subsection headings illustrated on p39 and the use of bullets on p48 help guide the reader's attention.  
Next, review the content format set forth for a CAM in AS 3101.14.
  - (a) Assume the lead header for the CAM is: *Goodwill Impairment Test for the Eastern Reporting Unit – Refer to notes 2 and 9 to the consolidated financial statements*. Suggest the next two CAM subheadings that recognize the requirements of AS 3101.14 - and also may help guide the shareholder in reading the CAM?
  - (b) What topic(s) within the CAM would you anticipate that bullets (or a numbered or lettered list) may help the reader by clearly identifying important information?
2. Write-up the CAM (i.e., Goodwill Impairment Test for the Eastern Reporting Unit) to be included in the auditor's report. Follow the guidelines set out in: AS 3101.14 and AS 3101.15. Make sure to incorporate subheadings and/or bullets where appropriate.

## Teaching Notes

### *Case Overview*

This hypothetical instructional case requires students to apply the recently issued Audit Standard 3101 (AS 3101) requiring, among other things, disclosure of critical audit matters (CAMs).<sup>1</sup> The case materials are designed to: familiarize students with recent changes to the auditor's report; guide the student through the critical thought process of identifying the relevant facts and circumstances upon which to determine if a matter rises to the level of a CAM; and provide experience writing up a CAM. In addition, since the case context includes a test for goodwill impairment, the simulation also provides students the opportunity to research and discuss the application of a recent accounting standard update relating to testing for goodwill impairment (AS 2017-04); as well as the risk factors associated with a fair value estimate.

The case culminates with the student reviewing the SEC handbook on: How to Create Clear SEC Disclosure Documents with respect to the use of vertical lists and subtitles; and then writing up the CAM for inclusion in the auditor's report. The write-up requires the application of vertical lists and subtitles as well as providing the specific content required by AS 3101.14 and AS 3101.15. See Exhibit A for an example screenshot of a difficult to read CAM from a Form 10k submission without subheadings or vertical lists.

### *Learning Objectives*

The case's primary learning objectives are accomplished through several pedagogical methods integrated into the case materials:

1. learning to identify, analyze and evaluate relevant facts and circumstances giving rise to a CAM (i.e., matters that involve especially challenging, subjective, or complex auditor judgment);
2. learning to identify, analyze and evaluate sources of uncertainty and judgment surrounding a fair value estimate, including the impact on the related audit effort;
3. research and discuss how the recent update/change to the goodwill impairment test is applied; and
4. finally, gaining hands-on experience writing up a CAM based on the facts, circumstances, and audit procedures identified in this simulation. In addition, students are required to familiarize themselves with and apply two relatively easy to implement SEC suggestions for writing clear disclosures as well as gain an awareness of a 'clear writing' resource.

### *Motivation*

After more than six years of discussion and analysis of comments from stakeholders, the Public Company Accounting Oversight Board (PCAOB) recently adopted AS 3101 requiring (among other things) the auditor's report to include CAMs. This new audit standard is particularly noteworthy because it's part of a global movement (International Auditing and Assurance Standards Board, the European Union, and the Financial Reporting Council in the United Kingdom) to expand the auditor's report to include audit-specific matters.

In addition, CAMS are of interest to academic researchers. For example, Brasel et al. (2016) and Gimbar et al. (2016a & 2016b), explore the potential for increased auditor liability. Pinello et al. (2020) analyze the interrelationship between critical accounting estimates and CAMs. While Hollie (2020), and Hollie and Yu (2020) investigate the prevalence and subject matter of CAMs; and found, among other things, that every audit report in their samples contained at least one CAM.

This case is unique. Since AS 3101 is a recent audit standard,<sup>2</sup> there are no instructional cases referencing/addressing CAMs. In addition, a review of the six most common audit textbooks in the United States (as

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<sup>1</sup> AS 3101.11 defines a CAM 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: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

<sup>2</sup> Large SEC accelerated filers (i.e., with public float of \$700 million and greater) were required to report critical audit matters for fiscal years ending on or after June 30, 2019; and all other filers for fiscal years ending on or after December 15, 2020. The effective date for all other requirements was December 15, 2017.

identified in Blix, Edmonds, and Sorensen 2021) finds that none of the textbooks provide an opportunity for students to apply AS 3101.

The PCAOB's Staff Outlook for 2021 Inspections, identifies CAMs as an important high priority area of planned inspection focus. The PCAOB further reinforces the high priority of CAMs by suggesting the audit committee ask the auditor: "What items, if any, were considered "close calls" but ultimately not identified as a CAM by the auditor? Why were these items not determined to be CAMs?"

This case also augments written communication functionality. Another recent PCAOB report of approximately 300 conversations with audit committee chairs discussed three core topics: the auditor and communications with the audit committee; new auditing and accounting standards; and emerging technologies (PCAOB 2021b). Among other things, the audit committee chairs identify both verbal and written communication "as extremely important to audit quality and their overall relationship with their auditors."

### ***Classroom Feedback***

Student feedback on this case exceeded our expectations as was the observable increase in student attention and enthusiasm for discussing an auditing standard in the context of a simulated assignment from their audit supervisor. In addition to selecting a well-known company, human capital metrics that the students may be familiar with are intentionally added to the general case background information (e.g., metrics from a popular social media website called Glassdoor, and certain employee benefits). The educational objective of the metrics is twofold. First, and foremost, to attempt to draw the student into the case by making the facts and circumstances personally relatable. Second, to raise student awareness of the global paradigm shift to provide human capital disclosures related to understanding a business as well as managing it. What makes these metrics particularly interesting (i.e., an optional discussion topic for either undergraduate or graduate students) is that the SEC rules do not include a definition of "human capital" or specify a list of required measures to disclose.

### ***Classroom Validation***

To assess the effectiveness of the case, we tested the case in three undergraduate audit classes at a large public university.<sup>3</sup> In each section, the case was assigned as a group project (two or three team members), and the students began completing the case following the kick-off discussion.

As part of the kick-off session (before starting the case), the students were asked to complete a pre-case survey that included (among other things) the self-assessment of their level of knowledge with respect to AS 3101 (see the Instrument attached as Appendix A). After the students completed the tasks required by the case and following the classroom wrap-up session, each student was then asked to complete a post-case self-assessment survey. Given the recent effective date for this auditing standard and the limited coverage in audit texts, it's not surprising that students assessed their pre-case knowledge level as low – while assessing their post case knowledge level as very high (see Table 1 questions 1 & 2 for further details).

112 undergraduate students were surveyed. Consistent with the extensive use of Likert scales dating from the 1930's (e.g., Smith 1994) and consistent with other audit related teaching cases (e.g., Andiola et al. 2018; Hess and Andiola 2018; and Andiola et al. 2021) the pre and post-case self-assessments were recorded using a 7-point Likert scale. Depending on the nature of the question: 1 represented Very Low Knowledge and 7 represented Very High Knowledge; or 1 represented Strongly Disagree and 7 represented Strongly Agree.

The case's primary learning objectives were accomplished (see Table 1). Generally, the students viewed the simulation as providing valuable knowledge and skills for their career. An unexpected finding was that students are generally not aware of the SEC handbook for creating clear disclosures, including the use/purpose of vertical lists and sub-titles. They also view the SEC handbook as a useful future resource. Finally, many students went so far as to say that writing up the CAM was: "what they liked most".

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<sup>3</sup> This study was reviewed and approved by our school's Institutional Review Board (IRB).

Other welcome observations included that the students found the case relatable; and the relatively higher level of student enthusiasm for learning an audit standard in the context of a simulation (vs. a lecture). The only suggestion to improve the case was to add hyper-links to facilitate direct access to the research materials. Researching audit/accounting topics “from scratch” is consistent with what will be expected from staff auditors during an audit engagement. Therefore, we did not implement this suggestion. Lastly, we note that despite the positive feedback a limitation of the survey is that it wasn’t designed to measure the student’s post-case level of knowledge.

### ***Implementation Guidance***

The case is designed for use in an undergraduate or graduate auditing class. Although the case focuses on CAMs, the Kick-off Overview section of Appendix B provides a summary of AS 3101 that includes the other non-CAM related changes to the audit report.

The more advanced topics identified at the end of Appendix B are primarily targeted to graduate auditing students but may be appropriate for your undergraduate class depending on their experience level and career interests/goals. The case content and tasks are typically associated with the completion phase of the audit; therefore, instructors may find this case most beneficial when discussing the auditor’s report. However, the very nature of a CAM provides an opportunity to review/apply what was previously discussed under the topic of ‘risk’.

We recommend that instructors assign or ask students to form teams of two (three, if necessary). To encourage student participation and learning, we also recommend that students/teams work independently on the assignment and then share their results during a class discussion. Students typically spend a total of 1 to 2 hours completing the assignment.

The optimal delivery structure for the case is a single class or portions of two-classes within the same week (with no more than a one-week gap between sessions). The optimum time to use the case is when covering the audit report. Alternatively, if instructors wish to reduce the amount of time students spend working on the case offline with their team at any one time, instructors could delay Part II (writing-up the CAM) until after you covered Part I. Therefore, Part II could be a standalone/follow-up exercise.

### ***Common Student Issues***

Similar to auditors in practice, students should initially be on their own to determine what must be done to complete their work assignment. Allowing students time to plan/figure out how to complete the case is important to prepare them for some of the ambiguity and uncertainty they will face as staff auditors during an audit engagement. In our field testing of the case, most students/teams were able to resolve their uncertainties and work through the case independently. However, in audit practice, an audit supervisor is often available to answer questions to guide staff auditors. As this case is designed for student learning, we suggest instructors provide guidance as necessary as a more experienced associate might (e.g., by pointing them in the right direction to look up the answer on their own).

### ***Grading***

We suggest instructors use a 3-point scale to grade each question. For example, students would receive 3 points for excellent answers, 2 points for good/average answers, and 1 or 0 points for poor answers. This could of course be modified depending on the skill level of your class. For instance, a pass/fail system could be used for a lower-level class while a more detailed 5-point scale could be used for a more advanced graduate class.

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**Table 1**  
*Pre and Post-Case Survey Results*

<b>Question:</b>	<b>Average Response (Pre)</b>	<b>Average Response (Post)</b>	<b>Sig.</b>
1. How knowledgeable are you with respect to audit standards/requirements for identifying a 'critical audit matter'?	3.28	5.13	<0.01
2. How knowledgeable are you with respect to the audit standard/requirements for reporting a 'critical audit matter' in the auditor's report?	3.15	5.18	<0.01
		<b><u>Average Response</u></b>	
3. Are you aware of or have you heard about the SEC Publication: "A Plain English Handbook: How to Create Clear SEC disclosure Documents?"		2.38	
4. I believe working on this case provided me with valuable knowledge and skills for my career.		6.17	
5. With respect to actually writing up a critical audit matter, did this case significantly raise your awareness that subsection headings and bullets are tools to add clarity?		6.15	
6. In addition to the use of subsection headings and bullets, has this case significantly raised your awareness that the SEC handbook is also a resource for additional suggestions to develop clearly written documents?		6.17	
7. Did your previous personal experience with Starbucks products/stores make the case more relatable and interesting to you?		5.46	
8. Did the Starbucks background information relating to the Glassdoor metrics and employee benefits make the case more relatable and interesting to you?		5.50	
9. Overall, the case significantly improved my level of comprehension, knowledge, and ability with respect to applying auditing standards relating to identifying and reporting a 'critical audit matter'.		6.07	
		<b><u>Yes</u></b>	<b><u>No</u></b>
10. Have you ever worked with critical audit matters before?		6%	94%
11. Have you had an internship as an audit professional?		14%	86%

This table presents the results from the pre and post-case survey of 112 auditing students. Questions 1-3 were captured on a 7-point Likert scale with 1 representing "Very Low Knowledge" and 7 representing "Very High Knowledge". Questions 4-9 were captured using a 7-point Likert scale with 1 representing "Strongly Disagree" and 7 representing "Strongly Agree". The results all support the case objectives.

## Appendix A - Pre and Post Case Instruments

### Pre-Case Assessment

For each statement below **choose the number** that most closely reflects your current knowledge/comfort with the described item.

1. How knowledgeable are you with respect to the audit standards/requirements for identifying a ‘critical audit matter’?

1	2	3	4	5	6	7
Very Low Knowledge						Very High Knowledge

2. How knowledgeable are you with respect to the audit standard/requirements for reporting a ‘critical audit matter’ in the auditor’s report?

1	2	3	4	5	6	7
Very Low Knowledge						Very High Knowledge

3. Are you aware of or have you heard about the SEC Publications: “A Plain English Handbook: How to Create Clear SEC Disclosure Documents?”

1	2	3	4	5	6	7
Very Low Knowledge						Very High Knowledge

4. Have you had an internship as an audit professional? Yes \_\_\_\_ No \_\_\_\_

5. Have you ever worked with Critical Audit Matters Before? Yes \_\_\_\_ No \_\_\_\_

Thank you for completing the pre-survey!

### Post-Case Assessment

For each statement below **choose the number** that most closely reflects your current knowledge/comfort with the described item.

1. How knowledgeable are you with respect to the audit standard/requirements for identifying a ‘critical audit matter’?

1	2	3	4	5	6	7
Very Low Knowledge						Very High Knowledge

2. How knowledgeable are you with respect to the audit standard/requirements for reporting a ‘critical audit matter’ in the auditor’s report?

1	2	3	4	5	6	7
Very Low Knowledge						Very High Knowledge

3. I believe working on this case provided me with valuable knowledge and skills for my career.

1	2	3	4	5	6	7
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Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
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4. With respect to actually writing up a critical audit matter, did this case significantly raise your awareness that subsection headings and bullets are tools to add clarity?

1	2	3	4	5	6	7
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree

5. In addition to the use of subsection headings and bullets, has this case significantly raised your awareness that the SEC handbook is also a resource for additional suggestions to develop clearly written documents?

1	2	3	4	5	6	7
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree

6. Did your previous personal experience with Starbucks products/stores make the case more relatable and interesting for you?

1	2	3	4	5	6	7
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree

7. Did the Starbucks background information relating to the Glassdoor metrics and two employee benefits make the case more relatable and interesting for you?

1	2	3	4	5	6	7
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree

8. Overall, the case significantly improved my level of comprehension, knowledge, and ability with respect to applying auditing standards relating to identifying and reporting a 'critical audit matter'.

1	2	3	4	5	6	7
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree

9. What did you like most about this case?

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Thank you for participating!

## Appendix B (For Instructors Only)

### Recommended Solutions to Case Requirements and Kick-Off (Overview of AS 3101)

#### *Kick-Off (Overview of AS 3101)*

On June 1, 2017, after more than six years of outreach and public comment, the PCAOB adopted a new reporting standard, AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion. The standard setting process included responding to written comments received from the concept release (June 2011), and later from a proposed standard (August 2013), and then from a repropose standard (May 2016). In addition, the process included oral comments received at a public meeting (April 2014) as well as multiple discussions of the proposal and reproposal at meetings of the PCAOB's Standing Advisory Group and Investor Advisory Group.

AS 3101, among other things, requires reporting CAMs in the auditor's report. In situations where the auditor determines that there are no critical audit matters, AS 3101.16 requires the auditor to include (under the section title "Critical Audit Matters") a paragraph defining a CAM; and a statement that "We determined that there are no critical audit matters".

In addition, as discussed in more detail below, the new standard also includes changes to format and layout, the use of standardized language, and clarification of certain auditor responsibilities. The effective date of AS 3101 varied according to the size of the filer as well as subject matter. Large SEC accelerated filers (i.e., with public float of \$700 million and greater) were required to report CAMs for fiscal years ending on or after June 30, 2019; and all other filers for fiscal years ending on or after December 15, 2020. The effective date for all other audit report requirements was December 15, 2017.

The new requirements relating to CAMs apply to all audits conducted under PCAOB standards except for certain entities. The requirement to report CAMS does not apply to: brokers and dealers reporting under Exchange Act Rule 17a-5; investment companies except for business development companies; employee stock purchase, savings and similar plans; or emerging growth companies.

Although some may view CAMs as the most impactful change to the audit report, there were other changes that future auditors should be aware of. In addition to the requirement to communicate CAMs in the auditor's report, AS 3101 adopts other changes that now require the auditor to:

- Include both shareholders and the board of directors (or equivalents for companies not organized as corporations) as addressees of the auditor's report. Additional addressees are optional. This change promotes consistency in that under the previous standard the auditor's report could be addressed to either or both.
- Use section titles (e.g., Critical Audit Matters) and position the "Opinion on the Financial Statements" section as the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. Note, this format change and the use of section titles to help guide the reader of the report, will make the auditor's report generally consistent with the International Standards on Auditing.<sup>4</sup> In addition, the auditor's report must include the title: "Report of Independent Registered Public Accounting Firm."

When the auditor decides to disclose information regarding the engagement partner and/or other accounting firms participating in the audit (see 3101.20 for content format), then the auditor should use an appropriate section title. Note however, the new standard does not specify a specific location within the auditor's report.

- Disclose the year in which the auditor began serving consecutively as the company's auditor. The disclosure of tenure encompasses the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit.

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<sup>4</sup> See International Standard on Auditing No.700 (Revised), Forming an Opinion and Reporting on Financial Statements for more details.

Therefore, identification of the initial year of service should give consideration to mergers, acquisitions, or changes in the ownership structure of the firm. Note, if the auditor is uncertain, the auditor should state and provide the earliest year of which the auditor has knowledge.

Finally, although auditors have discretion to present auditor tenure in whatever part of the auditor's report they consider appropriate, the illustrative auditor's report in the final standard includes the statement on auditor tenure at the end of the report.

- State in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is 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 SEC85 and the PCAOB. The statement is intended to enhance investors' and other financial statement users' understanding of the auditor's obligation to be independent.
- Identify (i.e., clarify) the notes to the financial statements and the related schedules as part of the financial statements that were audited. Under the previous standard, the notes to the financial statements and the related schedules were not specifically identified as part of the audit.
- Describe (i.e., clarify) the auditor's responsibility to obtain reasonable assurance that the financial statements are free of material misstatements - whether due to error or fraud.
- Provide a description of the nature of the audit reflecting the auditor's responsibilities in a risk-based audit and align the description with the language in the PCAOB's risk assessment standards, including:
  1. 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;
  2. Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
  3. Evaluating the accounting principles used and significant estimates made by management; and
  4. Evaluating the overall presentation of the financial statements.

Finally, the new standard also provides: an updated list of circumstances in which the auditor is required to add explanatory language to the auditor's report (see 3101.18); as well as the continuing ability for the auditor to add a paragraph to the auditor's report to emphasize a matter (see 3101.19) regarding the financial statements (i.e., an emphasis paragraph).

One item (3101.18(g)) that we believe deserves highlighting is the requirement for the auditor to add explanatory language in cases where the company is required to report on internal controls over financial reporting (ICFR) but has determined that it is not required to obtain (and did not request the auditor to perform) an audit of ICFR. For example, an explanation (in order to clarify, or limit the auditor's responsibility) that the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of the company's internal control over financial reporting. For companies where management is not required to report on ICFR, the auditor may choose to include a similar explanatory paragraph in the auditor's report voluntarily.

## Recommended Solutions to Case Requirements

### ***Part 1: Reviewing Critical Audit Matters and Deciding Whether to Report***

1. *Consult the guidance on what determines whether something should be reported as a CAM [see AS 3101.11]. What is the definition of a CAM?*

**Answer:** J. Robert Brown Jr., a PCAOB Board Member, (in a speech presented at the ICGN's Global Virtual Summit in November 2020) provides us with this informal definition: "Critical audit matters were intended to include the areas of the audit that kept the auditor up at night" (see PCAOB 2020).

Specifically, AS 3101.11 defines a CAM 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: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

### Discussion of key phrases in the Definition of a CAM:

*“... that was communicated or required to be communicated to the audit committee...”*

The definition of a CAM not only extends to matters that are required to be communicated to the audit committee (even if not actually communicated) – but also to matters actually communicated (even when not explicitly required). The auditor is also required to provide a draft of the auditor’s report to the audit committee and discuss the draft with them (AS 1301.21). Therefore, any matter that will be disclosed in the audit report as a CAM should already have been discussed with the audit committee.

Matters that are required to be communicated to the audit committee are identified in: AS 1301 (Communications with Audit Committees), including other PCAOB rules and standards listed in Appendix B; and applicable law (for example, Section 10A(k) of the Exchange Act, 15 U.S.C. 78j-1(k); Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Exchange Act Rule 10A-3, 17 CFR 240.10A-3).

For example, AS 1301 requires communication regarding:

- Significant risks identified by the auditor (AS 1301.09). Note, a significant risk is defined as a risk of material misstatement that requires special audit consideration (AS 2110).
- The nature and extent of specialists needed to audit and/or evaluate the audit results related to the significant risks (AS 1301.10);
- Certain matters (see AS 1301.12) regarding the company's critical accounting policies and practices (e.g. why are they considered critical), and estimates (e.g., describe the estimate process, any changes in the process, and management’s significant assumptions that have a high degree of subjectivity). Note: AS 1301 defines critical accounting policies and practices as a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results; and require management's most difficult, subjective, or complex judgments. A critical accounting estimate is where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and (b) the impact of the estimate on financial condition or operating performance is material.
- Significant unusual transactions (AS 1301.12k);
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process (AS 1301.24).

*“... relates to accounts or disclosures that are material to the financial statements ... “*

A CAM is not limited to audit matters that correspond to the entire account or disclosure in the financial statements. The words “relates to” makes it clear that a CAM could also be a component of a material account or disclosure. For example, the goodwill impairment test for one reporting unit (out of several reporting units) may be identified as a CAM. Consequently, the recorded value of the reporting unit represents just a portion of the total account balance for goodwill, including the related goodwill disclosure.

In addition, a company’s goodwill impairment assessment policy could be identified as a CAM even if there’s no impairment. For example, a Fortune 500 company recently reported a CAM relating to management’s determination of reporting units (see Table 2 below). Assuming goodwill is material to the financial statements, the CAM relates to the recorded goodwill and the disclosures in the notes to the financial statements. Finally, with respect to materiality, an audit matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter.

Additional guidance (in the form of examples) provided by the PCAOB includes:

- A CAM could represent a matter that has a pervasive effect on the financial statements if it relates to many accounts or disclosures (vs certain accounts or disclosures). For example, the company's ability to continue as a going concern could represent a critical audit matter depending on the circumstances of a particular audit.
- The definition of a CAM requires that the audit matter must relate to accounts or disclosures that are material to the financial statements. Therefore, 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 (even if it involved especially challenging auditor judgment). A similar rationale applies to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements.

- Similarly, the PCAOB noted that the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, is not a CAM. Why? because the 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.

To assist with comprehending how the requirements for disclosing a CAM are applied in practice and to appreciate the variety of topics associated with CAMs, let's look at some actual critical audit matter topics. The following partial listing was created from a review of 96 CAMS reported in a random sample of 50 SEC Form 10-K filings submitted by Fortune 500 companies (see Lynch 2021 for further details on this review):

- Membership rewards liability
- Fair value of embedded derivatives
- Allowance for loan losses
- Goodwill impairment
- Sufficiency of audit evidence for revenue
- Valuation of pension fund liability
- Valuation of environmental remediation
- Determination of reporting units
- Fair value of pension fund investments (e.g., privately held: debt, equity & real estate investments)
- Revenue contracts – assessing whether a service is 'distinct' for purposes of determining how and when revenue is recorded
- Reserve for insurance claims
- Fair value of franchise rights
- Fair value of trademarks
- Fair value of level 3 Instruments
- Impairment of oil & gas reserves
- Income tax – the realizability of deferred tax assets
- Nuclear decommissioning liability
- Legal contingencies (e.g., product liability lawsuits)

Note, identification of a CAM depends on the current facts and circumstances which are subject to change. Therefore, a CAM disclosed in the current year's audit report may not qualify in subsequent years.

**“... especially challenging, subjective, or complex auditor judgment.”**

See the discussion that follows in the solution to Question 2 below.

2. List 6 factors [AS 3101.12] that the auditor should take into consideration in determining that an audit matter involved: “*especially challenging, subjective, or complex auditor judgment.*”

**Answer:** In addition to being a 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; the auditor should determine if the matter involved: “*especially challenging, subjective, or complex auditor judgment*”. The determination should be made in the context of the particular audit (i.e., the specific facts & circumstances of the audit), rather than a discussion of generic risks. The auditor's determination that a matter is a CAM can be based on one or more factors listed below (or other factors specific to the audit). AS 3101.12 provides the following nonexclusive list of factors to consider:

- 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.

Note: The PSAOB expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

3. *What is a critical accounting estimate? Where are critical accounting estimates reported?*

**Answer:** An accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material (AS 16, Appendix A).

4. *What is the difference between a CAM and a critical accounting estimate? As an auditor do you anticipate that every critical accounting estimate disclosed by management will also be identified by you as a CAM (and reported in the audit report)?*

**Answer:** Although the answer is a simple ‘no’, these questions intend to stimulate discussion and challenge the student to think analytically by comparing the working definitions for critical accounting estimates and CAMs. In addition, the question provides context to spotlight a distinguishing incremental information contribution of a CAM (i.e., that the matter requires ‘especially’ challenging, subjective, or complex auditor judgment (and the steps taken by the auditor to mitigate the CAM). The new standard does not limit the source of CAMs to critical accounting policies and estimates because the Board does not believe this would be an appropriate starting point in light of investor interest in a broader range of topics related to the audit.<sup>5</sup>

There is some overlap between a CAM (reported in the audit report) and a related critical accounting estimate disclosed in MD&A. For example, shared subject matter; plus, they both encompass the concepts of materiality as well as the subjectivity and judgment involved in making the estimate. However, a CAM includes the additional requirement that there be a determination that the matter requires ‘especially’ challenging, subjective, or complex auditor judgment (and a related disclosure as to the steps taken to address the CAM in the audit).

Finally, while CAMs may appear to be subsets of critical accounting estimates, there are exceptions. For example, where an auditor identifies the evaluation of the identification of related parties and related party transactions as a CAM (and assuming there was not a corresponding subjective estimate or assumption made by management). Other examples include certain significant non-recurring transactions.

5. *Based on the conversation with your manager above and your research, does management’s test for goodwill impairment warrant being disclosed as a CAM in the audit report? Explain your answer.*

**Answer:** Yes. Based on the dialogue the testing for goodwill impairment is scheduled to be communicated with the audit committee. Plus, as noted in the dialogue, it relates to accounts or disclosures that are material to the financial statements; and involved ‘especially’ challenging, subjective, or complex auditor judgment. There are at least two factors that support the determination that this matter involved ‘especially’ challenging, subjective, or complex auditor judgment:

- a) 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
- 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.

Depending on their interpretation of the facts and circumstances of the case, students may argue that other factors apply. They may identify overlap between factors or suggest an additional factor. That’s ok because it encourages discussion and provides an opportunity to practice/develop professional communication skills. Based on the dialogue with the audit manager, we’re looking for at least two factors; and possibly more depending on the student’s ability to support a factor as requiring ‘especially’ challenging, subjective, or complex auditor judgment. In addition to becoming familiar with the requirements for a CAM, this particular topic opens the door for a lively discussion.

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<sup>5</sup> PCAOB Release No. 2017-001 June 1, 2017, p18.

6. How does the updated accounting standard for goodwill (AS 2017-04, issued January 2017) simplify the test for goodwill impairment? Who is affected? As an auditor, how often would you expect management to test for goodwill impairment (as part of your answer look up and cite the applicable paragraph in AS 2017-04).

**Reminder:** the text of question 5 advised the student that the required information to respond to this question is in the first 4 pages of AS 2017-04).

**Answer:** The student should have been exposed to this topic in other classes. The primary purpose of this question is to require the student to research a topic for the purpose of refreshing their memory during an audit.

AS 2017-04 modifies the concept of impairment from the condition that exists when the carrying amount of goodwill exceeds its implied fair value to the condition that exists when the carrying amount of a reporting unit exceeds its fair value. AS 2017-04 eliminates step 2 of the impairment test so that an entity will no longer determine goodwill impairment by calculating the implied fair value of goodwill by assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a business combination.

AS 2017-04 requires an entity to perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax-deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable.

AS 2017-04 applies to public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill.

### **Part 2: Writing a CAM**

1. Consult Chapter 7 (Designing the Document) of the SEC handbook on: How to Create Clear SEC Disclosure Documents. Observe how subsection headings illustrated on p39 and the use of bullets on p48 help guide the reader's attention.

Next, review the content format set forth for a CAM in AS 3101.14.

- a) Assume the lead header for the CAM is: *Goodwill Impairment Test for the Eastern Reporting Unit – Refer to notes 2 and 9 to the consolidated financial statements*. Suggest the next two CAM headings that recognize the requirements of AS 3101.14 - and also may help guide the shareholder in reading the CAM?

**Answer:** Critical Audit Matter Description; and How the Critical Audit Matter Was Addressed in the Audit

- b) What topic(s) within the CAM would you anticipate that bullets (or a numbered or lettered list) may help the reader by clearly identifying important information?

**Answer:** The number of topics will vary depending on what topics (if any) are included in the introductory text leading to the list. In our example, we use 3 bullets to list topics under the two subheadings: Critical Audit Matter Description; and How the Critical Audit Matter was Addressed in the Audit. See the example write up that follows.

2. Write-up the CAM (i.e., Goodwill Impairment Test for the Eastern Reporting Unit) to be included in the auditor's report. Follow the guidelines set out in: AS 3101.14 and AS 3101.15. Make sure to incorporate subheadings and/or bullets where appropriate.

**Answer:** The disclosure should start with the definition of a CAM and for each CAM: describe/identify the CAM, including the related financial statement accounts or disclosures; provide the principal considerations that led the auditor to determine that the matter is a CAM; and describe how the CAM was addressed in the audit. See the solution that follows.

## Example Write Up Of: The Critical Audit Matter

### Critical Audit Matter

The critical audit matter communicated below is a matter that arose from the current period audit of the consolidated 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 consolidated 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.

### Goodwill Impairment Test for the Eastern Reporting Unit – Refer to Notes 2 and 9 to the consolidated financial statements

#### Critical Audit Matter Description

The Company's consolidated goodwill balance was \$6.8 billion as of December 28, 202x. Management recognized an impairment of \$350 million for the current reporting year. As discussed in Note 2, goodwill is tested for impairment for each reporting unit at least once a year; or more frequently if events or circumstances indicate it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Goodwill is tested for impairment by comparing the estimated fair value of the reporting unit to its carrying value. If the estimated fair value is less than the carrying amount, an impairment loss is recorded based on the difference between the fair value and carrying amount, not to exceed the associated carrying amount of goodwill. Management uses the discounted cash flow (DCF) method to estimate fair value. The fair value calculation requires management to use significant estimates and assumptions related to forecasting future operating cash flows.

We identified the fair value calculation as a critical audit matter because auditing management's estimates and assumptions required auditor judgment that was especially challenging, subjective, and complex. Specifically, our principal considerations were:

- Management's fair value calculation required a significant degree of judgment including estimates with significant measurement uncertainty.
- Planning, implementing, and reviewing the results of the related audit procedures required a higher degree of auditor judgment and effort. For example, evaluating management's estimated cash flow projections and significant business assumptions, including estimated sales (volumes and pricing), operating costs, capital spending, discount rates and long-term growth rates.
- This audit matter required the involvement of a fair value specialist.

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

We tested the effectiveness of internal controls relating to management's annual goodwill impairment assessment, including the determination of the reporting unit. A valuation specialist assisted us with planning and implementing the audit procedures for the critical audit matter. The specialist also assisted with the evaluation of audit evidence, including the reasonableness of management's fair value calculation.

Our audit procedures for testing the reasonableness of management's estimate of fair value included evaluating the appropriateness of using a DCF model as well as the completeness, relevance and accuracy of data inputs and related assumptions. In addition, we:

- performed sensitivity analyses on key assumptions (e.g., the discount rate, and growth rates for sales volumes and prices);
- compared the data inputs and related assumptions (as well as the final results) for consistency with external market and industry data, including specific peer companies; and
- compared the final results (management's forecasted future cash flows) for consistency with the current and past performance of the operating unit, as well as with evidence obtained in other areas of the audit.

**Optional Discussion Topics (Assignments) for Graduate Students**

1. The PCAOB expected that, in most audits, the auditor would disclose at least one critical audit matter. Compare the PCAOB's initial anticipated number of CAMS to the actual numbers reported by the Center for Audit Quality; and list the most frequently reported categories of CAMs (See <https://www.thecaq.org/wp-content/uploads/2020/12/caq-critical-audit-matters-year-in-review-2020-12.pdf>).

**Answers:** Number of CAMS reported on p4: Within the S&P 100, every auditor's report in the population contained at least one CAM. There were 198 total CAMs in the population, for an average of just under two (1.98) CAMs per report. There was a single auditor's report that communicated five CAMs, while 32 auditor's reports communicated only one CAM

Most frequently reported on p6: Of the 198 CAMs identified within auditor's reports in the S&P 100, there were four common categories of CAMs: taxes (32 CAMs), goodwill and/or intangibles (28 CAMs), contingent liabilities (23 CAMs), and revenue (18 CAMs). <https://www.thecaq.org/wp-content/uploads/2020/12/caq-critical-audit-matters-year-in-review-2020-12.pdf>

2. Extend the discussion of the answer to 5-b (i.e., 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.) to identify additional examples of management judgment/estimates.

**Answer:** Cost of products sold, SG&A, depreciation and amortization, working capital, capital expenditures, and income tax rates.

3. Select a SEC 10-K filing where a critical accounting estimate is also reported as a CAM by the auditor. Compare the two disclosures in terms of content (how do they differ).
4. Microsoft Word provides a feature to calculate the CAM write-up's Flesch-Kincaid Grade Level (readability) score as well as the usage of passive voice. In addition, there are free sites available for calculating readability metrics for a document (e.g., <https://readabilityformulas.com/>).

In addition to writing up the CAM, have the students calculate their write-up's Flesch-Kincaid Grade Level (readability) and usage of passive voice. Require the students to research and report to the class on the results in terms of how readable their write-up is.

Readability formulas share a common flaw in that they are unable to directly assess the content and instead tend to focus on word count, syllables per word, words per sentence, and number of sentences. Therefore, while the score may provide some useful feedback, it cannot by itself assure that a disclosure is easy to understand. This exercise is intended to sensitize students to 'readability'; and inform the student of a resource available to them to improve their writing skills over the course of their career. We selected the Flesch-Kincaid Index because of its long history of use in research (e.g., Gao et al. 2020 and Schroeder and Gibson 1990), plus it is conveniently accessible in Microsoft Word.

As noted in the SEC Handbook, active voice is quicker and easier to understand because it follows how we naturally think and process information. Passive voice, on the other hand, forces readers to take extra mental steps as they convert the passive into the active. However, the passive voice may make sense when the person or thing performing the action is of secondary importance to another subject that should play the starring role in sentence. Therefore, in the words of the SEC Handbook: "Don't ban the passive voice, but use it sparingly."

**Exhibit A****Example Screenshot of a CAM from a Form 10k Submission without Subheadings or Vertical Lists***Income taxes*

As described in Notes 1 and 8 to the consolidated financial statements, the Company's total income tax expense for the period ended December 31, 2019 was \$374 million. The Company has deferred income tax liabilities, net, of \$1,619 million (including a valuation allowance of \$408 million) and unrecognized income tax benefits of \$1,552 million as of December 31, 2019. As disclosed by management, the Company operates in numerous countries under many legal forms and, as a result, is subject to the jurisdiction of numerous domestic and non-U.S. tax authorities, as well as to tax agreements and treaties among these governments. Determination of taxable income in any jurisdiction requires management to interpret the related tax laws and regulations and to use estimates and assumptions regarding significant future events, such as the amount, timing and character of deductions, permissible revenue recognition methods under the tax law and the sources and character of income and tax credits. Management assesses income tax positions and records tax benefits for all years subject to examination based upon evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where it is more likely than not that a tax benefit will be sustained, management has recorded the largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more likely than not that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. Management estimates the degree to which tax assets will result in a benefit, after consideration of all positive and negative evidence, and provides a valuation allowance for tax assets that it believes will more likely than not go unused. In situations in which management has been able to determine that the Company's deferred tax assets will be realized, that determination generally relies on future reversals of taxable temporary differences and expected future taxable income. If it becomes more likely than not that a tax asset will be used, management reverses the related valuation allowance. The principal considerations for our determination that performing procedures relating to income taxes is a critical audit matter are there was significant judgment by management when determining the provision for income taxes, deferred tax assets and liabilities, and liabilities for unrecognized tax benefits due to numerous and complex tax laws, the frequency of tax filings, as well as judgments regarding the realizability of deferred tax assets. This in turn led to a high degree of auditor judgment, subjectivity, and effort in performing procedures and evaluating audit evidence related to the provision for income taxes, deferred tax assets and liabilities, and

liabilities for unrecognized tax benefits. In addition, the audit effort involved the use of professionals with specialized skill and knowledge to assist in performing these procedures and evaluating the audit evidence obtained from these procedures.

Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the financial statements. These procedures included testing the effectiveness of controls relating to the provision for income taxes, deferred tax assets and liabilities, and liabilities for unrecognized tax benefits, including controls over management's assessment of the realizability of deferred tax assets. These procedures also included, among others, (i) testing the accuracy of the income tax provision, including the rate reconciliation and permanent and temporary differences, (ii) evaluating whether the data utilized in the calculation of the provision for income taxes was appropriate and consistent with evidence obtained in other areas of the audit, (iii) evaluating management's assessment of the realizability of deferred tax assets on a jurisdictional basis, (iv) evaluating the identification of reserves for unrecognized tax benefits and the reasonableness of the "more likely than not" determination in consideration of jurisdictions, court decisions, legislative actions, statutes of limitations, and developments in tax examinations, (v) testing the calculation of the liability for unrecognized tax benefits by jurisdiction, including estimates of the amount of tax benefit expected to be sustained, and (vi) evaluating the adequacy of the Company's disclosures. Professionals with specialized skill and knowledge were used to assist in evaluating the reasonableness of management's judgments and estimates, including application of foreign and domestic tax laws and regulations.

\*Note – the sentence break and extra spacing between paragraphs is from a page break.