

## PCAOB Adopts Standard on Auditor Communications with Audit Committees

At its open meeting on August 15, 2012, the Public Company Accounting Oversight Board adopted Auditing Standard No. 16, *Communications with Audit Committees*, and related amendments to other PCAOB standards.<sup>1</sup> AS 16 requires auditors to engage in certain communications with audit committees and is intended to foster a meaningful dialogue on important audit and financial statement matters. The PCAOB expects more effective two-way communications to enhance audit quality and strengthen audit committee oversight. The new standard is subject to approval by the Securities and Exchange Commission.

AS 16 and related amendments will supersede the PCAOB's interim auditing standard AU section 380, *Communication with Audit Committees*, and AU section 310, *Appointment of the Independent Auditor*. Although the new standard will be effective for audits for fiscal years beginning on or after December 15, 2012, its requirements will be relevant throughout 2013. Some of the required communications, such as those relating to the terms of the audit engagement and the overall audit strategy, will be relevant as planning for the 2013 audit begins. Moreover, related amendments to AU section 722, *Interim Financial Information*, will apply to reviews of interim financial information beginning with the first quarter of 2013. As amended, AU section 722 requires auditors to, among other things, "determine whether any of the matters described in [AS 16], as they relate to interim financial information, have been identified" and to communicate those matters to the audit committee "in a timely manner and prior to the registrant filing its periodic report with the SEC." Audit committees should therefore familiarize themselves now with the new requirements.

More generally, audit committees should use the adoption of AS 16 as an opportunity to reexamine the quality of their current communications with the auditor. Its discussions with public company audit committee members led the PCAOB to conclude that the scope, content and quality of communications with auditors are variable, and AS 16's common baseline for communications is intended to help remedy that problem. The PCAOB has also been clear in crafting AS 16 and other recent regulatory initiatives that it believes it has a role to play in enhancing audit committee oversight even though, it readily

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<sup>1</sup> PCAOB Release No. 2012-004 (Aug. 15, 2012). For the text of the new standard, please see appendix 1 of the adopting release, which is found at [http://pcaobus.org/Rules/Rulemaking/Docket030/Release\\_2012-004.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf).

concedes, it lacks authority over audit committees.<sup>2</sup> While the PCAOB also acknowledges that an audit committee could refuse to cooperate with an auditor's efforts to communicate, PCAOB staff observed in the open meeting that an auditor faced with an obstructionist audit committee may need to consider whether that conduct signals a material weakness or significant deficiency, requires a limitation-of-scope qualification in the audit report or indicates a need to perform additional audit procedures.

Finally, AS 16 should be of interest not only to audit committees but also to financial intermediaries and their counsel when performing diligence related to securities offerings, as it provides a checklist of matters of interest about a company's financial statements and related disclosures. Because AS 16 permits auditor communications to be made orally or in writing (as discussed below), review of audit committee minutes alone may not disclose the substance of the communications.

### **Selected Communication Requirements under AS 16**

The adoption of AS 16 follows a lengthy rulemaking process that began in March 2010 and involved both a proposal and reproposal of the standard.<sup>3</sup> The final standard addresses many of the comments received, notably by focusing the required communications on significant matters tied to existing audit procedures. We highlight below the most significant of the requirements included in the final standard.

***Understanding of the Terms of the Audit.*** Under AS 16, the auditor must establish an understanding with the audit committee about the terms of the engagement, including the audit objective and the auditor's and management's responsibilities. While similar to the existing requirement in AU section 310, *Appointment of the Independent Auditor*, AS 16 specifically requires that the understanding be with the audit committee and not the "client" to avoid any confusion about the proper counterparty and to align the requirements with the committee's responsibility to retain the auditor.

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<sup>2</sup> On August 1, 2012, the PCAOB issued PCAOB Release No. 2012-003 titled "Information for Audit Committees About the PCAOB Inspection Process." The stated purpose of the release is "to assist audit committees in (1) understanding the PCAOB's inspections of their audit firms and (2) gathering useful information from their audit firms about the inspections." The release describes the PCAOB inspection process and suggests specific questions an audit committee may ask its auditor regarding the inspection of its firm. In addition, although the PCAOB is precluded by law from publicly disclosing certain aspects of its inspections (and thus cannot adopt rules directing audit firms to release this information to the audit committees of their clients), the PCAOB encourages audit committees to inquire into such matters, as well as to access the portions of the PCAOB inspections that are publicly available.

<sup>3</sup> Please see PCAOB Release No. 2010-001 (Mar. 29, 2010) and our alert memorandum dated April 1, 2010 ([http://www.cgsh.com/pcaob\\_proposes\\_new\\_standard\\_on\\_auditor\\_communications\\_with\\_audit\\_committee](http://www.cgsh.com/pcaob_proposes_new_standard_on_auditor_communications_with_audit_committee)) for information on the standard as originally proposed and PCAOB Release No. 2011-008 (Dec. 20, 2011) and our alert memorandum dated December 22, 2011 ([http://www.cgsh.com/pcaob\\_reproposes\\_standard\\_on\\_auditor\\_communications\\_with\\_audit\\_committee](http://www.cgsh.com/pcaob_reproposes_standard_on_auditor_communications_with_audit_committee)) for information on the standard as repropounded.

This understanding, among other matters, must be recorded in an engagement letter, which the auditor must provide to the audit committee annually even if there is no change to the letter from year to year. The standard requires the engagement letter to be executed “by the appropriate party or parties on behalf of the company.” The auditor may rely on the company to identify the appropriate party unless it has evidence to the contrary; it is not necessary that any particular party, such as management, execute the letter. If the engagement letter is executed by someone other than the audit committee or its chair, however, the auditor must confirm that the committee has acknowledged and agreed to its terms. The standard does not prescribe the form of the acknowledgement, but permits the auditor to request that it be in writing and requires an oral acknowledgement to be documented in accordance with AS 16’s documentation standard (described below).

***Information Relevant to the Audit.*** Under AS 16, the auditor “should inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations.” The standard expands the inquiries auditors must make under AS 12, *Identifying and Assessing Risks of Material Misstatement*, about the committee’s knowledge of the risks of material misstatement, including fraud risks. The PCAOB declined a commenter’s request that the standard list all the matters that may be “relevant to the audit,” observing that these would (and should) vary by audit. The PCAOB also dismissed a concern that this requirement risks making the audit committee (rather than management) the original source of information for the auditor, stating that the standard is a means for the auditor to gain the committee’s additional perspective. Finally, the PCAOB did not modify the requirement in response to concerns that these communications could cause the underlying information to lose the protection of the attorney-client privilege. The PCAOB did not deny this possibility, but emphasized that the purpose of the requirement is to enable the auditor to have the information necessary to conduct an effective audit.

In the reproposal, the inquiries would have extended to matters “that might be” relevant to the audit. This language was removed in the final standard to avoid a potentially over-broad communication. Along similar lines, the PCAOB removed the reference in the reproposal to “complaints or concerns [received by the audit committee] regarding financial reporting matters,” since this inquiry would duplicate those called for by AS 12, *Identifying and Assessing Risks of Material Misstatement*.

***Accounting Policies and Practices, Estimates, and Significant Unusual Transactions.*** AS 16 requires auditors to convey to audit committees information relating to the company’s significant accounting policies and practices, critical accounting policies and practices, critical accounting estimates and significant unusual transactions.

With respect to critical accounting policies and practices,<sup>4</sup> AS 16 incorporates the requirement set out in Section 10A(k) of the Securities Exchange Act of 1934 and Rule 2-07(a)(1) of Regulation S-X that an auditor communicate to the audit committee “all critical accounting policies and practices to be used.” The standard likewise reflects guidance contained in the SEC release adopting Rule 2-07 of Regulation S-X<sup>5</sup> that obliges the auditor to discuss “[h]ow current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.” Some commenters had objected to this requirement, arguing that an auditor is unable to predict the future. The PCAOB rejected these comments, asserting that the SEC’s guidance makes this a mandatory component of the communication.

Communications about significant unusual transactions have two parts. First, the auditor must inform the committee of “[s]ignificant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.” Second, the auditor must describe management’s policies or practices in accounting for those transactions. The PCAOB did not limit this requirement to transactions that raise significant risks as recommended by one commenter, stating that transactions that do not raise significant risks nonetheless may be used to mislead investors and should be communicated to the committee.

The PCAOB acknowledged that management may already communicate with the audit committee about the company’s significant accounting policies and practices, critical accounting policies and practices, critical accounting estimates and significant unusual transactions. To avoid duplication, the auditor need not communicate these matters “at the same level detail as management,” so long as it (i) participates in management’s discussion with the committee about them, (ii) affirmatively confirms to the committee that the matters have been adequately conveyed by management and (iii) in the case of critical accounting policies and practices, identifies those policies and practices the auditor considers critical. The standard requires the auditor to fill gaps left by management’s communications, whether because management neglected to describe a matter or because its description was inadequate.

***Evaluation of the Quality of the Company’s Financial Reporting.*** In addition to providing information about the company’s significant accounting policies and practices, critical accounting policies and practices, critical accounting estimates and significant

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<sup>4</sup> Critical accounting policies and practices are those “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, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.” The standard clarifies that critical accounting policies and practices “are tailored to specific events in the current year” and that the policies and practices considered “critical” may vary from year to year. The PCAOB further notes in the adopting release that critical accounting policies and practices are a “subset” of significant accounting policies and practices.

<sup>5</sup> SEC Release No. 33-8183 (Jan. 28, 2003).

unusual transactions, an auditor must also communicate its evaluation of these and other matters. Specifically, AS 16 requires communications regarding:

- certain qualitative aspects of the company’s significant accounting policies and practices, including in relation to identified bias in management’s judgments about the amounts and disclosures in the financial statements;
- the auditor’s assessment of management’s disclosures with respect to critical accounting policies and practices;
- the grounds for the auditor’s conclusions with respect to the reasonableness of critical accounting estimates;
- the understanding the auditor has formed with respect to the business rationale for significant unusual transactions;
- the auditor’s evaluation of the conformity of the financial statements and related disclosures with the applicable financial reporting framework;
- the identification, if any, by the auditor of a concern with respect to management’s anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting; and
- all alternative treatments for policies and practices “related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.”

Many of these requirements adapt provisions of AU section 380 to reflect current auditing standards. For example, while AU section 380 requires the auditor to apprise the audit committee of its judgments about the quality, not just the acceptability, of the company’s accounting principles, AS 16 requires the auditor to communicate the results of its evaluation of and conclusions about the qualitative aspects of the company’s significant accounting policies and practices. AS 16 also omits language from AU section 380 providing that the auditor communicate its views on the clarity and completeness of the financial statements and disclosures. This language had been criticized as confusing, and the new standard simply links the communication requirement to the related obligation under AS 14, *Evaluating Audit Results*.

***Other Firms or Persons Performing Audit Procedures.*** Under AS 16, the auditor must communicate to the audit committee an overview of the overall audit strategy. The reproposal would have required the auditor to report the “names, locations, planned roles, and responsibilities, including the scope of audit procedures, of other independent public accounting firms or other persons ... that perform audit procedures in the current period audit.” The PCAOB eliminated the requirement to report the “planned roles” and “the scope

of audit procedures” of other firms to align the requirement with AS 10, *Supervision of the Audit Engagement*, which speaks only in terms of “responsibilities,” and AU section 543, *Part of Audit Performed by Other Independent Auditors*. The PCAOB also clarified that the auditor must communicate information about “other independent public accounting firms that perform procedures in the current audit period,” regardless of the relationship they have with the principal auditor.

***Company’s Status as a Going Concern.*** AS 16 requires an auditor to communicate matters relating to its evaluation of the company’s ability to continue as a going concern, including (i) conditions and events that, when considered in the aggregate, lead the auditor to believe that there is substantial doubt about the company’s ability to continue as a going concern for a reasonable period of time, (ii) the auditor’s assessment regarding the efficacy of management’s plans for dealing with identified conditions and events and (iii) if substantial doubt remains, the effects, if any, on the company’s financial statements, related disclosures, or the auditor’s report.

As noted above, AS 16 requires the auditor to communicate its evaluation of a company’s ability to continue as a going concern if the auditor “*believes there is* substantial doubt about the company’s ability to continue as a going concern for a reasonable period of time” (emphasis added). The reproposal would have required the auditor to communicate “[t]he conditions and events the auditor identified that, when considered in the aggregate, indicate that there *could be* substantial doubt about the company’s ability to continue as a going concern for a reasonable period of time” (emphasis added). The modified threshold better aligns AS 16 with AU section 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*, which requires the auditor to consider management plans for addressing adverse conditions and events if the auditor believes there is substantial doubt about the company’s continued status as a going concern.

***Uncorrected and Corrected Misstatements.*** AS 16 states that the auditor should provide the audit committee with the schedule of uncorrected misstatements related both to accounts and disclosures that it provided to management and discuss with the committee (or determine that management has adequately discussed with the committee) the basis for the conclusion that the misstatements are immaterial, including the qualitative factors considered. The new standard also requires the auditor to communicate that uncorrected misstatements could cause future financial statements to be materially misstated even if immaterial to the current period audit. The auditor must also communicate any non-trivial corrected misstatements and discuss their implications for the company’s reporting process.

***Other Matters Affecting the Audit.*** AS 16 requires the auditor to communicate a number of matters that are relevant to the audit process itself. These include:

- disagreements with management about matters that alone or together could be significant to the financial statements or the auditor’s report, whether or not they were resolved satisfactorily;
- difficulties encountered in performing the audit, including (among others) significant management delays or management’s unwillingness to provide needed information and unreasonable management restrictions on the conduct of the audit;
- difficult or contentious matters for which the auditor consulted outside the engagement team (including any consultation with the engagement quality reviewer) and are reasonably determined by the auditor to be relevant to the committee’s oversight responsibility;
- management’s consultation with other accountants about significant auditing or accounting matters as to which the auditor has identified a concern; and
- material written communications with management.

***Form and Documentation of Communications.*** With few exceptions (*e.g.*, terms of the audit engagement), AS 16 does not prescribe the form that required communications must take. Communications may be made orally or in writing and may take the form of “presentations, charts, written reports, or robust discussions.” The PCAOB noted that the form of the communication may depend on the nature of the information to be conveyed (*e.g.*, written communication may facilitate the communication of highly complex information). The PCAOB stressed at the open meeting and in the adopting release that the standard is intended to introduce a flexible framework consistent with the robust dialogue the standard is intended to foster.

All communications that an auditor makes to the audit committee, whether oral or written, must be documented in the work papers. The documentation is subject to AS 3, *Audit Documentation*, which requires the inclusion in the work papers of “sufficient information to enable an experienced auditor, having no previous connection with the engagement[,] ... [t]o understand” the communication. If the auditor does not communicate certain matters at the same level of detail as management (as described above under “Accounting Policies and Practices, Estimates, and Significant Unusual Transactions”), the documentation must include a copy or a summary of management’s communication to the audit committee.

***Timing of Communications.*** Under AU section 380, audit committee communications are identified as incidental to the audit and, so long as they occur on a timely basis, not required to occur before issuance of the auditor’s report. AS 16 requires the auditor to make all communications in a timely manner and *prior* to the issuance of the auditor’s report (unless otherwise required by PCAOB rules or standards or the securities

laws). The PCAOB declined to specify what would be appropriate timing, noting that it might vary based on the circumstances, including whether corrective action or follow-up is needed and whether relevant rules, standards or laws dictate specific timing requirements.

In the reproposal, communication to the “full” audit committee was required prior to issuance of the auditor’s report. In response to comments that this was an unnecessary burden since the auditor should be permitted to communicate to the committee when a quorum is present, the final standard was revised to eliminate the word “full.”

### **Application of AS 16 to Brokers, Dealers and Emerging Growth Companies**

AS 16 will not govern the audits of brokers and dealers or “emerging growth companies”<sup>6</sup> unless the SEC takes the additional rulemaking steps described below.

***Brokers and Dealers.*** Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB has authority over the audits of financial statements of SEC-registered brokers and dealers. The SEC has proposed, but has not adopted, amendments to Rule 17a-5 under the Exchange Act to enable the PCAOB’s authority.<sup>7</sup> If the SEC adopts the Rule 17a-5 amendments or provides other direction that auditors of brokers and dealers must comply with PCAOB standards before AS 16 takes effect, the new standard will be applicable to audits of brokers and dealers on its effective date. If the SEC takes action prior to the effective date of AS 16, transitional amendments to AU section 380 will make those provisions applicable to the audits of brokers and dealers in the interim.

***Emerging Growth Companies.*** Under the JOBS Act, AS 16 will only apply to audits of emerging growth companies if the SEC determines “that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.” The PCAOB has recommended that AS 16 apply to the audits of emerging growth companies and has prepared, with the SEC’s assistance, an analysis supporting that recommendation. At the open meeting, one PCAOB member described the process of forming this recommendation as “a challenging learning experience” and acknowledged the painstaking work that reaching similar conclusions with respect to other pending standard-setting projects (as well as incorporating economic analysis into the PCAOB standard-setting process more generally) will entail.

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<sup>6</sup> An issuer qualifies as an “emerging growth company” if it, among other things, had total annual gross revenues of less than \$1 billion during its most recent fiscal year. For more information about emerging growth companies and the JOBS Act more generally, please see our alert memorandum dated March 27, 2012 ([http://www.cgsh.com/jobs\\_act\\_to\\_relax\\_rules\\_on\\_securities\\_offerings](http://www.cgsh.com/jobs_act_to_relax_rules_on_securities_offerings)). AS 16 is the first standard adopted by the PCAOB following enactment of the JOBS Act.

<sup>7</sup> SEC Release No. 34-64676 (June 15, 2011).

***Definition of “Audit Committee” in the case of Nonissuers.*** AS 16 applies to audits of certain nonissuers, mainly brokers and dealers, that often do not have governance structures comparable to those of public companies. For the entities that do not have an audit committee or a board of directors (or an equivalent body), the “audit committee,” for the purposes of AS 16, will be deemed to be the person(s) who “oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.” While the reproposal required communications to be made to the person(s) “designated to oversee” those processes, the PCAOB removed this concept in the standard to focus the definition on “the person(s) identified by the auditor” as having oversight responsibility.

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Please feel free to call any of your regular contacts at the firm or any of our partners and counsel listed under “Capital Markets” or “Corporate Governance” under the “Practices” section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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