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PCAOB Proposes New Standard on Auditor Communications with Audit Committee

Introduction

At an open meeting on March 29, 2010, the Public Company Accounting Oversight Board proposed for comment a new auditing standard to clarify and expand the requirements for auditors' communications with audit committees. The proposing release is available at http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf. Comments on the proposed standard are due by May 28, 2010.

The proposed standard represents a further effort to promote dialogue between the auditor and the audit committee about accounting and auditing matters, notably about significant risks and the use of judgments and estimates in the specific context of a company's financial reports. The stated objectives of the PCAOB in advancing the proposed standard are to "(1) enhance the relevance and effectiveness of the communications between the auditor and the audit committee; and (2) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit." More importantly, a key unstated premise is that audit committees may not now be sufficiently well-equipped to provide effective oversight of public company financial statements and the financial reporting process.

While the PCOAB members uniformly acknowledged the central role of the well-informed audit committee in effective financial oversight, one member expressed skepticism as to whether auditing standards can be expected to prompt better two-way communication or whether improvements are more likely to be a function of overall board and company culture. Similarly, during an October 2009 meeting of the PCAOB's Standing Advisory Group ("SAG"), a number of SAG members noted that robust engagement and dialogue between the audit committee and the auditor is often primarily a function of the personalities and qualifications of audit committee members and the lead audit partner, rather than rules or standards.

Skepticism in this area would not be unfounded. Existing rules and standards of accounting and other regulatory bodies already require extensive communication between the auditor and the audit committee. There is a natural (and perhaps inevitable) tendency for mandated auditor communications to evolve into routine, highly stylized reports that reflect a focus on demonstrating compliance as much as providing information. Discussions at the October 2009 SAG meeting, as well as SAG meetings in prior years, have articulated concerns that such communications can easily become "boilerplate" in nature and that rules and standards are not ideal tools to stimulate a more robust dialogue.

The importance of the proposed standard and its underlying message should therefore not be underestimated. Even pending the adoption of the new standard, audit committees should evaluate the quality of their existing dialogue with the auditor and ways that it can be improved. Audit committees should also consider whether other board or committee-level activities complement effectively the mandated auditor communications. These activities include the audit committee's executive sessions with the auditor and key management personnel (e.g., the head of internal audit and the compliance officer), management presentations about significant accounting policies and other key elements of the company's financial presentation, as well as the board's overall approach to director orientation. Audit committees should assess whether these activities and reports, taken together, assure that they are receiving both candid appraisals of material financial reporting matters and sufficient contextual information to facilitate their oversight responsibility.

Summary of the Proposed Standard

The proposed standard would replace the PCAOB's interim auditing standards AU section 310, *Appointment of the Independent Auditor*, and AU section 380, *Communication With Audit Committees*. The new standard would incorporate substantially all of the communication requirements now contained in AU section 380, but also cover additional matters.[1] The principal new requirements are as follows:

Audit Engagement and Strategy

Audit Engagement Letter. The proposed standard would require that the auditor establish a mutual understanding of the terms of the audit engagement with the audit committee (rather than the audit client under current requirements) and to record the understanding in a written engagement letter presented to the audit committee each year.

Overview of Audit Strategy. The proposed standard would require the auditor to provide an overview of the planned audit strategy, including a discussion of the significant risks identified by the auditor's risk assessment procedures. The PCAOB's chairman explained at the open meeting that this communication is intended to make the audit

[1] Other PCAOB standards and rules require auditor communication to the audit committee in connection with specific matters, such as Rule 3526, *Communication with Audit Committees Concerning Independence*, AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. These other standards and rules would be listed in an appendix to the proposed new standard.

committee more effective by providing more timely information about the auditor's views of risks and how they will be addressed in the audit. The auditor would also be required to communicate any significant changes to the planned audit strategy or the significant risks initially identified. Communications about audit strategy would include the auditor's planned use of specialists, internal audit personnel or other third parties, and the roles and responsibilities of other firms involved in the audit.

Issues Arising from the Audit

The proposed standard would require more extensive communications about accounting policies, practices and estimates. The changes reflect a recognition that management judgments and estimates, particularly fair value estimates, are increasingly important in financial reporting frameworks. For example, an October 2009 PCAOB discussion paper suggested that the "susceptibility of management's judgments and estimates to misstatements due to their complex nature" supports the notion that the auditor should provide more information to the audit committee in this area. In a similar vein, at the open meeting, the PCAOB's chairman noted the heightened focus that the recent financial crisis has placed on management's judgments and estimates, especially those related to fair value.

Significant Accounting Policies. In addition to requirements paralleling those in AU section 380, the proposed standard would require the auditor to communicate the anticipated application by management of accounting or regulatory pronouncements that have been issued but are not yet adopted by the company and may have a significant effect on financial reporting.

Critical Accounting Estimates. Under the proposed standard, the auditor would be required to communicate information about critical accounting estimates, including:

- significant assumptions used;
- significant changes to assumptions or processes made in the year under audit (including the reasons for the changes, the effects on the financial statements, and the information that supports or challenges such changes);
- when critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and how various selections within the range would affect the financial statements; and
- both the auditor's evaluation of the reasonableness of the process used by management to develop critical accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

At the open meeting, the PCAOB staff indicated that the proposed standard uses the term "critical accounting estimates" as used in SEC guidance,[2] rather than the term "particularly sensitive accounting estimates" used in AU section 380, in order to help auditors determine what estimates must be communicated.

Communications by Management. The proposed standard would permit management to communicate all of the matters described above to the audit committee, but the auditor would be required to evaluate the adequacy of the communication. If the auditor concluded that the communication was not sufficient, it would be required to make its own communication to the audit committee to correct any inadequacy.

Management Bias on Accounting Estimates. The proposed standard would require the auditor to inform the audit committee if the auditor determines that potential bias exists in management's accounting estimates.[3]

Evaluation of the Quality of the Company's Financial Reporting. As under AU section 380, the proposed standard would require the auditor to communicate its evaluation of the quality, and not just the acceptability, of the company's significant accounting policies and practices. This communication would include a discussion of the quality, clarity and completeness of the company's financial statements, including related disclosures. In addition, the proposed standard would require communication similar to the requirements of Rule 2-07 of Regulation S-X about critical accounting policies and practices and alternative treatments for policies and practices related to material items discussed with management.

Audit Adjustments. The proposed standard would expand required communications with respect to audit adjustments. For uncorrected misstatements, the auditor would be required to present the audit committee with the same schedule of accounting disclosures as was presented to management. It is noteworthy in this regard that the PCAOB staff emphasized at the open meeting that a summary showing only the net effect of uncorrected misstatements could be misleading. The auditor would also be required to communicate the

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2 *See* Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8350 (Dec. 19, 2003). In that release, the SEC stated that companies should provide disclosure about accounting estimates or assumptions where "(i) the nature of the estimates or assumptions 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 (ii) the impact of the estimates and assumptions on financial condition or operating performance is material."

3 Paragraph 27 of the PCAOB's Proposed Auditing Standard, *Evaluating Audit Results*, requires the auditor to evaluate possible management bias in accounting estimates. The Proposed Auditing Standard gives as an example of possible management bias a situation in which "each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income."

basis for determining that the uncorrected misstatements were immaterial, as well as the qualitative factors considered. The proposed standard also would require communication of corrected misstatements that might not have been detected but for the audit.

Outside Consultations. Under the proposed standard, the auditor would be required to inform the audit committee of the auditor's consultations outside the audit engagement team on significant accounting matters, including with the auditor's national office. The PCAOB staff explained that this requirement will provide the audit committee with timely information about "complex transactions that may be high risk or controversial." As a practical matter, consultations with the auditor's national office are often a "yellow flag," and the specific requirement that the auditor report on these consultations should cause the audit committee, if it has not already done so, to make specific queries of both management and the auditor about the basis for, and risks entailed by, the accounting treatment finally applied to the matters in question.

Going Concern Status. Under existing standards, the auditor must evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[4] Under the proposed standard, these obligations would be supplemented by explicit communication requirements. If the auditor determines that there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, but that doubt is mitigated, the proposed standard would require the auditor to communicate the conditions and events that, when considered in the aggregate, indicated there could be substantial doubt, as well as the information that mitigated the auditor's doubt. If the auditor determines that there could be such substantial doubt, and that doubt is not mitigated, the proposed standard would require additional communications. Consistent with existing standards, when a company faces a "going concern" issue, auditors must consider the adequacy of the related disclosure. Often the resulting financial statement disclosure will address the type of information highlighted in the proposed standard. The new communication requirement will ensure that these matters also have a full airing before the audit committee, so that the committee can better probe management (and the auditor) about the reasonableness of management's plans and, where applicable, the clarity and completeness of related disclosures.

Other Significant Matters. The proposed standard would add a requirement for the auditor to communicate other matters arising from the audit that are significant to the oversight of the financial reporting process, such as complaints or concerns raised with respect to auditing or accounting matters. Most audit engagement letters require that the company disclose to the auditor illegal acts, among other matters, as a result of the auditor's own obligations under Section 10A of the Securities Exchange Act of 1934 to include, as

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4 *See* AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. The release notes that this standard may change as a result of the Financial Accounting Standards Board's pending project on going concern.

part of the audit, "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."[5] The new requirement would draw further attention to this element of the audit and, for those companies that do not already do so, likely prompt more formal procedures by management to systematically alert the auditor to these types of concerns. As discussed below, the auditor must also make inquiries of the audit committee about these concerns.

Timing and Form of Communications

Written or Oral Communication. Auditors would continue to have the flexibility to make required communications in either oral or written form under the proposed standard. At the open meeting, the PCAOB staff explained that written communication was not mandated because of concerns that such a requirement might chill communications. In any event, regardless of form, the auditor would be required to document the communication in sufficient detail to enable an experienced auditor[6] with no prior connection with the engagement to understand what was communicated. As a matter of practice, it seems unlikely that the auditor would materially exceed the scope of the work papers that document the communication. We also note that work papers are generally discoverable in litigation and are of course made available to the PCAOB in its inspections of registered public accounting firms.

Timing. The proposed standard would provide that all required communications must be made annually before the issuance of the auditor's report (and in any event must be timely). It would also require the auditor to make any relevant required communications before the company's release of interim financial information.

Encouraging Two-Way Communication

Inquiries by Auditor. The proposed standard would require the auditor to ask the audit committee whether the committee is aware of matters that may be related to the audit, including complaints or concerns raised regarding auditing or accounting matters. This requirement is intended to align with the audit committee's responsibility under SEC and stock exchange rules to establish procedures for the receipt, retention and treatment of complaints and concerns about accounting and auditing matters.

5 *See also* AU section 316, *Consideration of Fraud in a Financial Statement Audit* and AU section 317, *Illegal Acts by Clients*, which set out additional communication requirements on the part of the auditor in this area.

6 *See* Auditing Standard No. 3, *Audit Documentation*, which states that an "experienced auditor has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

Auditor's Evaluation. The proposed standard would add a requirement that the auditor evaluate, before the issuance of its report, whether the two-way communication between the auditor and the audit committee has been adequate to support the objectives of the audit. If not, the auditor must evaluate the effects (if any) on the risk of material misstatements and its ability to obtain appropriate and sufficient audit evidence, and take appropriate action. The proposed standard lists some of the matters that the auditor should consider when reaching its conclusion, including:

- the appropriateness and timeliness of actions taken by the audit committee in response to matters raised by the auditor;
- the openness of the audit committee in its communications with the auditor;
- the willingness and capacity of the audit committee to meet with the auditor without management present; and
- the extent to which the audit committee probes issues raised by the auditor.

Discussion at the open meeting raised the obvious conflict-of-interest question presented by this aspect of the proposed standard – can the auditor effectively and candidly make this evaluation when it involves the body responsible for the auditor's own engagement? The answer doubtless depends on the circumstances of the particular company and committee, including the personalities involved. Nevertheless, the new requirement should, as discussed above, stimulate renewed focus by audit committees to determine whether their current practices promote the kind of dialogue that yields a meaningful context for evaluating the company's financial reporting process and disclosures.

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