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PCAOB Reproposes Standard on Auditor Communications with Audit Committees

At its open meeting on December 20, 2011, the Public Company Accounting Oversight Board reproposed an auditing standard that would clarify and expand the requirements for auditor communications with audit committees.[1] The standard as reproposed represents a significant improvement over the original 2010 proposal, which was criticized as potentially overwhelming audit committees with immaterial information and making the communications a "check-the-box" compliance exercise. In response, the PCAOB has tailored the reproposed standard to focus on communications that will facilitate audit committee oversight of the financial reporting process.

The new standard would supersede the PCAOB's interim auditing standards AU section 380, *Communication With Audit Committees*, and AU section 310, *Appointment of the Independent Auditor*. Comments on the reproposal are due by February 29, 2012, and the PCAOB intends to adopt a final standard that would be effective, subject to approval by the Securities and Exchange Commission, for financial statement audits for fiscal years beginning on or after December 15, 2012.

Audit committees should not wait for adoption of the final standard before assessing the quality of their communications with the auditor. The core principle underpinning the proposed standard is incontrovertible: a robust and candid dialogue with the auditor is critical to the effectiveness of the audit committee. With the significant additional responsibilities undertaken by audit committees in the last decade, the risk that the dialogue could become stylized and stale is significant. The audit committee's annual self-evaluation, typically undertaken around year-end, would be an ideal forum for the committee to take a fresh look at its interactions with the auditor. The audit committee should also consider whether other board or committee-level activities complement effectively its discussions with the auditor. These include the committee's practices for executive sessions and the scope and quality of management presentations to the committee about key accounting, control and financial presentation matters.

We summarize below the key changes made by the PCAOB in its reproposal.

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[1] PCAOB Release No. 2011-008 (Dec. 20, 2011). The text of the reproposed standard may be found at http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2011-008.pdf. For information about the original proposal, 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).

Emphasis on Dialogue through Required Inquiries of Audit Committee

The standard as reproposed includes a new objective of the auditor to "[o]btain information from the audit committee relevant to the audit." The inclusion of this objective gives greater prominence to the principle that effective two-way communications cannot depend exclusively on the input of the auditor. The reproposal retains the requirement that the auditor make inquiries of the audit committee, but clarifies their scope.

Notable among the information to be solicited is the audit committee's knowledge of "violations or possible violations of laws or regulations." Under the standard as originally proposed, the required inquiry was limited to "complaints or concerns raised regarding accounting or auditing matters," although the PCAOB stated that this language was not intended to be so limited. Noting that the audit committee may become aware at various times of ethics violations or concerns about the company's financial reporting, the PCAOB states that discussions about them should be "robust and substantive," and urges performing this procedure early in the audit process to enable appropriate and timely adjustments to the audit strategy.

The PCAOB rejected one commenter's suggestion that the audit committee's response be documented in a representation letter similar to those executed by key management personnel in connection with financial statement reviews and audits. In this regard, the PCAOB distinguished between the responsibilities of management and the audit committee, noting that management, by virtue of its responsibilities for the preparation of financial statements and the company's operations, can be expected to have sufficient knowledge to provide representations. The PCAOB noted, however, that the reproposal would not preclude the auditor from requesting a representation letter from the audit committee and that AU section 333, *Management Representations,* now provides that the auditor may, in some cases, wish to obtain written representations from other parties. Although we agree with the PCAOB that a representation letter from the audit committee should not be mandated, the standard will, if it is adopted as reproposed, likely drive more robust management reporting to the audit committee about these matters in order to enable the committee to respond appropriately to the auditor's inquiry.

More Focused and Meaningful Communications

While the overall approach of the original proposal has been retained in the reproposal, the PCAOB revised it in several respects to narrow the scope of the required communications, align them more closely with the auditor's existing performance obligations and improve their meaningfulness.

Elimination of Some Requirements. Among the communications eliminated in the reproposal are the following:

- The auditor need not "evaluate whether the two-way communications between the auditor and the audit committee have been adequate to support the objectives of the audit." Commenters questioned whether an auditor could make this evaluation, given the obvious conflict of interest it presents, and expressed skepticism that the evaluation would promote effective two-way communications.

- In response to concerns about the appropriateness, scope and practicality of required communications about critical accounting estimates, the auditor need not communicate (i) how management monitors critical accounting estimates after they are developed, and (ii) the impact on the company's financial statements of selecting different points within a range for a given estimate. The PCAOB noted, however, that SEC interpretive guidance effectively calls for this information to be addressed in Management's Discussion and Analysis[2] and that the auditor is obligated to consider whether the information presented or the manner of its presentation "is materially inconsistent with the information in the financial statements or is a material misstatement of fact."[3]

Alignment of Communications with Existing Performance Obligations. The PCAOB stressed during the open meeting that the proposed requirements are not intended to impose additional performance obligations on auditors, but to ensure that the auditor conveys to the audit committee important issues that emerge while fulfilling its existing obligations. In some cases, the revisions also reflect the limitations that are inherent in the auditor's role as such. Examples of these changes include the following:

- The auditor need not discuss with the audit committee the "[q]uality, clarity, and completeness of the company's financial statements" and related disclosures. This requirement sought to build on AU section 380's requirement that the auditor "discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting" and the related guidance about what that discussion should generally cover. In response to concerns about what a mandatory communication would entail, the PCAOB revised the standard to require only that the auditor report its evaluation of whether the financial statements and related disclosures have been

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2 *See* SEC Release No. 33-8350 (Dec. 19, 2003).

3 *See* AU section 550, *Other Information in Documents Containing Audited Financial Statements*. The PCAOB also reminded practitioners that the SEC's definition of "critical accounting estimate," retained in the reproposal, is "used to help focus the communication to the audit committee on those estimates, including certain fair value estimates, that might be subject to a higher risk of material misstatement," noting that "[t]he definition of a critical accounting estimate is intended to include those estimates deemed 'particularly sensitive' under AU sec. 380."

presented in accordance with the applicable financial reporting framework. The revised approach is consistent with Auditing Standard No. 14's requirement that the auditor evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable framework.

- The reproposal eliminates the requirement to report the auditor's evaluation of the reasonableness of management's process to develop critical accounting estimates, a change that responded in part to concerns that this could create the appearance that the auditor is making decisions on behalf of management. At the same time, the reproposal clarifies the requirements pertaining to critical accounting policies and practices that it retains from the original proposal, including by narrowing the scope of communications on the reasons certain policies and practices are considered critical, in response to commenters' observations that existing SEC rules also require the auditor to make communications to the audit committee about those matters.

- The original proposal required the auditor to report the basis for its determination that uncorrected misstatements were immaterial, but commenters objected that management is responsible for evaluating the materiality of uncorrected misstatements and communicating their conclusions to the audit committee. The reproposal now requires the auditor to discuss (or determine that management has adequately discussed) with the committee "the basis for the determination that the uncorrected misstatements were immaterial."

- The reproposal now incorporates the SEC's requirement that an auditor communicate to the audit committee other material written communications between the auditor and management.

- Various revisions reflect matters addressed in eight new risk assessment standards[4] that the PCAOB adopted after the release of the original proposal. Some of these revisions resulted in new or expanded reporting obligations. For example, the auditor must communicate the results of its assessment of the qualitative aspects of the company's significant accounting policies and practices, including any bias the auditor detects in management's judgments about the amounts and disclosures in the financial statements, instead of only communicating any determination that potential bias exists in management's accounting estimates. Consistent with Auditing Standard No. 14, the reproposal further expands reporting about bias to require the auditor to communicate its evaluation of whether "the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management."

[4] PCAOB Release No. 2010-004 (Aug. 5, 2010).

- Consistent with the auditor's obligations under AU section 316, *Consideration of Fraud in a Financial Statement Audit*, the reproposal now requires the auditor to report to the audit committee any significant transactions of which the auditor has become aware that are outside the normal course of business or that otherwise appear to be unusual due to their timing, size or nature and to include the auditor's understanding of the business rationale for the transactions.

Notably, the PCAOB declined to adopt several commenters' suggestion that the revised standard require the auditor to report its assessment of the company's "tone at the top." As observed by one PCAOB member at the open meeting, Auditing Standard No. 5 addresses a company's "tone at the top" insofar as it requires the auditor to evaluate management in connection with gaining an understanding of the company's control environment.

Revised Focus on Matters of Significance. To promote the exchange of more meaningful and relevant information, the PCAOB limited the scope of several requirements, including the following:

- The auditor need not alert the audit committee to all "[s]ignificant accounting matters for which the auditor has consulted outside the engagement team," but only those consultations that involve "difficult or contentious" matters[5] and are relevant to the audit committee's oversight of the financial reporting process in the judgment of the auditor.

- Many of the requirements were revised to limit communications so that they relate only to matters of significance. For example:

  - The original proposal required that the auditor communicate all discussions it has with management about the application of accounting principles and auditing standards at the time of the auditor's engagement or retention, whereas the reproposal requires that only "significant" discussions be reported.

  - In communications about the audit strategy, the original proposal required a discussion of whether "persons with specialized skill or knowledge" are required in connection with the audit or to evaluate audit results, whereas the reproposal revised this communication to cover "the nature and extent" of

5 The PCAOB's commentary about "difficult or contentious matters" is noteworthy. The reproposal characterizes them as "those critical matters that have concerned the auditor when he or she is making the final assessment of whether the financial statements are presented fairly. A difficult issue might not always be synonymous with a contentious issue. Rather a difficult issue might be a matter that requires significant consultation. A contentious issue might be a matter that not only requires significant consultation but also leads to significant points of disagreement, debate, or deliberation between the auditor and management."

specialized skill or knowledge needed to evaluate "audit results related to significant risks."

  - The reproposal requires communications about significant changes management makes to significant assumptions underlying critical accounting estimates, whereas the original proposal covered all assumptions.

  - The reproposal limits the auditor's communication about management's consultation with other accountants to significant auditing or accounting matters about which the auditor has a concern.

- In other cases, the revisions refocus the topic of the communication to provide a more valuable perspective. For example, the original proposal required the auditor to communicate the anticipated application of new, but not yet effective, accounting pronouncements. Recognizing that this would do nothing more than reiterate financial statement disclosures, the reproposal reorients the communication to "situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application" of such a pronouncement. The PCAOB notes that the auditor "might be concerned about changes to accounting or disclosure processes, or systems that could affect financial reporting or whether management has devoted adequate resources to the pending adoption."

Elimination of Duplicative Communications. The PCAOB acknowledged that management may already discuss with the audit committee or otherwise disclose some of the matters that would be the subject of mandatory communications under the standard as originally proposed. The reproposal revises some requirements to avoid this duplication, including as noted above in connection with uncorrected misstatements. In the case of accounting policies, practices and estimates, the reproposal takes a similar, although more prescriptive, approach. If management has already discussed with the audit committee aspects of those matters that would otherwise be subject to the new standard, the auditor need not address those matters with the same degree of detail as long as the auditor (i) participates in management's discussion of these matters with the audit committee, (ii) affirmatively confirms to the audit committee that management's discussion was adequate and (iii) identifies those accounting policies and practices that the auditor considers critical.

Additional Required Communications

The standard as reproposed would impose a limited number of other requirements not contained in the original proposal in addition to those already noted above. For example, the auditor must determine that the audit committee has acknowledged and agreed to the terms of the engagement in the event that the engagement letter memorializing those terms is signed by someone other than the audit committee or its chair. While many audit engagement letters include an acknowledgement by the audit committee, the reproposal clarifies that the acknowledgement may be made orally. The reproposal also clarifies that the engagement letter need only be "provided" annually to the audit committee, thereby avoiding confusion about whether it must be "prepared" annually.

Application to Audits of Broker-Dealer Financial Statements

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB now has authority over the audits of the financial statements of SEC-registered brokers and dealers, and the SEC proposed rules in June 2011 to enable the PCAOB's responsibility. As reproposed, the standard would apply to financial statement audits of SEC-registered broker-dealers, although the PCAOB concedes that the financial reporting framework and supervision mechanisms of smaller broker-dealers are likely to differ in many respects from those of public companies. The PCAOB solicited comment on the operation of the reproposal in connection with broker-dealer financial statement audits. As a transitional measure, the PCAOB is also proposing to apply the current interim standards governing auditor communications to broker-dealer financial statement audits in the event that the SEC's proposed rules become effective before the effectiveness of the new standard on auditor communications.

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