

**Agenda Item 10**

---

---

**Standing Advisory Group Meeting**

**June 21-22, 2004**

**Potential Standard – Communications and Relations with Audit Committees**

---

---

**Introduction**

The Standing Advisory Group ("SAG") will discuss the current Public Company Accounting Oversight Board ("PCAOB") interim auditing standard on communications with audit committees, and whether that standard should be revised to address the new requirements of the Sarbanes-Oxley Act of 2002 (the "Act") that affect audit committees, including all required communications between the auditor and the audit committee. The purpose of the discussion with the SAG is to review (a) the new requirements of the Act that affect audit committees, (b) the auditor's communication requirements under the existing auditing standards, (c) a recommendation for a new standard on communications with audit committees, and (d) the related issues raised both by the adoption of the Act and the rules of the Securities and Exchange Commission ("SEC") implementing relevant sections of the Act.

**Requirements of the Sarbanes-Oxley Act of 2002**

The Act contains the following provisions that affect an issuer's audit committee—

- Section 201 of the Act requires the audit committee to pre-approve any non-audit services, including tax services, that are not on the prohibited list for an issuer's auditor.

This paper was developed by the staff of the Office of the Chief Auditor in order to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.

- Section 202 of the Act requires the audit committee to pre-approve all services (including audit services, review services, services performed in connection with attest engagements required under securities laws, and non-audit services) to be provided by the auditor.
- Section 204 of the Act requires an auditor to communicate, on a *timely* basis, the following information to an issuer's audit committee—
  - a. All critical accounting policies and practices to be used;
  - b. All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor; and
  - c. Other material written communications between the auditor and the management of the entity, such as a management letter or a schedule of unadjusted differences.
- Section 204 defines *on a timely basis* as prior to the filing of the financial statements and auditor's report with the SEC. Although Section 204 does not require the auditor to make the communications in writing, it does require the auditor to document any communications made orally.
- Section 301 of the Act states that the audit committee of an issuer with securities listed on a national exchange is responsible for the appointment, compensation, retention, and oversight of the work of a registered public accounting firm; thus, the auditor must report directly to the audit committee.

## Existing Auditing Standards on Communications with Audit Committees

### **SAS No. 61, *Communication with Audit Committees***

SAS No. 61, *Communication with Audit Committees* (AU sec. 380),<sup>1/</sup> requires an auditor to communicate certain matters to the audit committee in connection with an audit of financial statements. SAS No. 61 applies to companies that have an audit committee and to all SEC engagements, as defined in the standard.

SAS No. 61 requires the auditor to communicate a number of items to the audit committee during the course of the financial statement audit, including the following–

- *The auditor's responsibility under generally accepted auditing standards.* The auditor is required to communicate the nature of assurances provided in an audit, as well as the level of responsibility he or she assumes under generally accepted auditing standards ("GAAS"). The auditor also is required to communicate the assertion that an audit is designed to provide reasonable, but not absolute, assurance about the financial statements.
- *Significant accounting policies and unusual transactions.* The auditor should determine that the audit committee is informed about: (a) the initial selection of accounting policies, (b) changes in significant accounting policies, (c) changes in the application of significant accounting policies, and (d) methods used to account for significant unusual transactions or emerging issues for which there is a lack of authoritative standards or support.
- *Management's judgments and accounting estimates.* The auditor should ensure that the audit committee is informed about the process management uses to formulate accounting estimates, especially particularly sensitive estimates, and about the basis for the auditor's conclusions regarding the reasonable of those estimates.
- *Audit adjustments.* The auditor should report to the audit committee adjustments arising from the audit that could, in his or her judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. The auditor also should report to the audit committee uncorrected misstatements aggregated by the auditor during the engagement that were determined by

---

<sup>1/</sup> The PCAOB adopted as its interim auditing standards those auditing standards promulgated by the AICPA as of April 16, 2003.

management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

- *Auditors' judgments about the quality of the issuer's accounting principles.* The auditor should report to the audit committee the auditor's judgments about the quality—not just the acceptability—of the entity's accounting policies as applied in its financial statements. This discussion, which should be both open and frank and generally should include management, should address matters such as (1) the consistency of the entity's accounting policies and their application, (2) the clarity and completeness of the financial statements, including related disclosures, and (3) items that have a significant effect on the representational faithfulness, verifiability, and neutrality of accounting information included in the financial statements. Examples of items that may have such an impact are the changes to or the selection of new accounting policies; estimates, judgments, and uncertainties; unusual transactions; and accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded.
- *Other Information in Documents Containing Audited Financial Statements.* The auditor should discuss with the audit committee his or her responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.
- *Disagreements With Management.* The auditor should discuss with the audit committee any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or to the auditor's report.
- *Consultation With Other Accountants.* When consultation with other accountants about auditing and accounting matters has occurred, the auditor should discuss with the audit committee his or her views about significant matters that are the subject of such consultation.
- *Major Issues Discussed With Management Prior to Retention.* The auditor should discuss with the audit committee any major issues discussed with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions regarding the application of accounting principles, auditing standards, and auditor independence matters.
- *Difficulties Encountered in Performing the Audit.* The auditor should inform the audit committee of any serious difficulties he or she encountered in dealing with

management related to the performance of the audit including, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information.

SAS No. 61 considers the required communications *incidental* to the audit. Thus, it does not require the auditor to make the required communications before issuing the audit report, as long as they occur on a *timely basis*.

SAS No. 61 acknowledges that it might be appropriate for management to make some of the required communications to the audit committee directly. In that case, however, the auditor should be satisfied that such communications have been made. The standard also states that it is not necessary for the auditor to repeat the communications each year. However, it cautions the auditor to consider whether to repeat the communications because of changes to the audit committee or due to the passage of time.

SAS No. 61 permits the auditor to make the required communications either orally or in writing. The auditor should document oral communications in the working papers. Written communications are to be restricted to the use of the audit committee and others within the company.

### **Other Auditing Standards**

In addition to the requirements of SAS No. 61, a number of other auditing standards require an auditor to communicate certain matters to the audit committee in connection with a financial statement audit. Appendix A lists those standards; it also provides a brief discussion of the circumstances in which they apply.

### **Recommendations for Consideration of a New Standard on Communications with Audit Committees**

A new standard on communications with audit committees and boards of directors may help ensure that auditors understand and satisfy their responsibilities related to communications with audit committees.

*Existing Standards Do Not Address The New Communications Mandated By The Sarbanes-Oxley Act of 2002.* As previously discussed, Section 204 of the Act requires an auditor to communicate, on a timely basis, certain information to an issuer's audit committee.

*Existing Standards Do Not Describe Certain Important Aspects of the Relationship Between The Auditor And The Audit Committee.* A number of provisions in the Act affect an issuer's audit committee. In some cases, those new provisions also govern the communications an auditor should make to the audit committee to enable it to effectively fulfill its oversight function. For instance, Section 202 of the Act requires an issuer's audit committee to pre-approve *all* services to be provided by the company's auditor.<sup>2/</sup>

Additionally, Section 301 of the Act states that the audit committee of an issuer with securities listed on a national exchange is responsible for the appointment, compensation, retention, and oversight of the work of a registered public accounting firm. Thus, the auditor must report directly to the audit committee. SAS No. 1, *Appointment of the Independent Auditor* (AU sec. 310), provides requirements relating to establishing an appropriate understanding with the client, including the factors that should be discussed with the client and the use of engagement letters. Because of the new requirements in Section 301, however, the auditor is now required to obtain an understanding directly with the audit committee, rather than with management (with whom the auditor generally has spoken in the past).

*Existing Standards Do Not Address All Required Audit Committee Communications.* Existing auditing standards do not adequately address all required communications between the auditor and the audit committee. SAS No. 61, for example, considers communications with an audit committee to be *incidental* to an audit of financial statements. However, due to investors, regulators, and others placing increased oversight responsibilities on an issuer's audit committee, relevant communications from the auditor are essential for the audit committee to meet its obligations.

In addition, Independence Standards Board Statement No. 1, *Independence Discussions with Audit Committees*, issued in January 1999, requires the auditor, on at least an annual basis, to—

---

<sup>2/</sup> SEC rules require disclosure of the aggregate fees billed in each of four categories for the two most recent fiscal years. See *Final Rule: Strengthening the Commission's Requirement's Regarding Auditor Independence*, Securities and Exchange Commission Release No. 33-8183 (February 5, 2003) [68 FR 6006].

- Discuss with the audit committee any relationship with the company that, in the auditor's judgment, might reasonably be thought to bear on independence;
- Include in a letter to the audit committee a discussion of such relationships, as well as a statement that the firm is independent; and
- Discuss independence with the audit committee.

## **Related Issues Raised by the Adoption of the Act and the SEC's Related Implementation Rules**

### **Communications to the Board of Directors**

SAS No. 61 requires the auditor to communicate certain matters directly to the audit committee. Unless the issuer does not have an audit committee, in which case SAS No. 61 directs the auditor to make the communications directly to the board of directors, that standard does not require the auditor to make any specific communications directly to the entire board of directors.

With the issuance of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, however, the auditor has a new responsibility, in certain circumstances, to communicate information directly to an issuer's entire board of directors. In fact, PCAOB Auditing Standard No. 2 requires an auditor to communicate in writing to the board of directors the existence of a significant deficiency or material weakness resulting from his or her belief that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective. Although that responsibility relates only to an auditor performing an integrated audit of financial statements (that is, an audit of internal control performed in conjunction with an audit of financial statements), the Board has proposed an amendment to the interim auditing standards that would incorporate a similar responsibility for an auditor who performs only a financial statement audit.<sup>3/</sup>

---

<sup>3/</sup> The proposed standard titled, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, would amend SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, (AU sec. 325).

Finally, Section 10A of the Securities and Exchange Act of 1934 requires an auditor to communicate directly to an issuer's entire board of directors when the auditor concludes that an illegal act has a material effect on the financial statements of the issuer and (a) senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act and (b) the failure to take remedial action is reasonably expected to warrant departure from the auditor's standard report or resignation from the audit engagement.

**Discussion Question –**

1. Because of an auditor's responsibility to communicate certain items directly to an issuer's entire board of directors, should a standard on auditor communications with the audit committee include communications with the board of directors?

**Form of Required Auditor Communication**

Section 204 of the Act permits an auditor to make the mandated communications to the audit committee either *orally* or in *writing*. Likewise, SAS No. 61 allows an auditor the same flexibility when making the required communications. (Both directives require the auditor to document the communication in the working papers when he or she elects to make the communications orally.)

However, investors and others are placing increasing importance on the effectiveness of an audit committee's oversight in ensuring the reliability of an issuer's financial reporting. Because the auditor's communications are crucial to the audit committee's ability to effectively fulfill its role, requiring an auditor to make the required communications in *writing* might make it easier for an auditor to document his or her compliance with the applicable rules of the Act. Written communications also might make it easier for an audit committee to ensure that it has all of the information it needs to comply effectively with the Act's new requirements, including the pre-approval requirements in Section 202.

**Discussion Question –**

2. Should a standard on communications with audit committees require an auditor to make all required communications to the audit committee in *writing*?
-

3. Alternatively, should a standard require only that certain matters be communicated in writing? If so, which matters should be required?

### **Timeliness of Required Communications**

As previously discussed, any new standard on communications with an audit committee would incorporate those matters required to be communicated by (a) SAS No. 61, (b) other existing auditing standards, and (c) Section 204 of the Act. While each group of required communications mandates the auditor to make the communications *on a timely basis*, they each define *timeliness* in a different manner. For instance, SAS No. 61 requires an auditor to make the communications *on a timely basis*; however, it does not provide an explanation of what is meant by timeliness. In fact, with respect to timeliness, SAS No. 61 states only "there may be occasions when discussion of certain of the matters with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable."

In addition, other auditing standards (See Appendix A) require an auditor to communicate with an audit committee only when certain circumstances apply (for instance, when an illegal act is suspected). Therefore, such standards generally provide little specific discussion on the timeliness of such communications.

Finally, Section 204 of the Act requires the auditor to communicate (a) critical accounting policies and practices, (b) alternative accounting treatments, and (c) other material written communications to the audit committee *on a timely basis*. The SEC's rules<sup>4/</sup> relating to the timeliness of such communications provide further discussion of what is considered timely by stating that an auditor should communicate such matters to the audit committee *before the auditor's report is filed with the SEC*.

In summary, while there are a number of standards an auditor can follow to determine when he or she should make a specific communication, the requirements seem to differ depending upon the type of communication being made.

### **Discussion Questions –**

4. Should a standard on communications with audit committees define *timeliness based* on the matter to be communicated? In other words, should the *timeliness*

---

<sup>4/</sup> See *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Securities and Exchange Commission, Release No. 33-8183, (February 5, 2003) [68 FR 6006]*.

of the communication be gauged by the type of communication the auditor makes? Alternatively, should the standard define timeliness in the same way for all required communications?

5. Ultimately, should the auditor's decision about what constitutes a timely communication be based on other factors, such as the relative significance of the matter noted and the urgency of corrective follow-up action required? (If the auditor were to encounter significant difficulties with management or other matters that are adversely affecting the progress of the audit, for example, should the standard require the auditor to communicate those matters to the audit committee as soon as practicable?)

### **Mandatory Engagement Letter**

SAS No. 1, *Appointment of the Independent Auditor* (AU sec. 310), requires the auditor to obtain an understanding with the client regarding the services to be performed; it also provides a list of matters to be discussed with the client as part of the understanding. AU sec. 310 also sets forth standards for an auditor on establishing an understanding with the client, including the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. While acknowledging that these matters "may be communicated in the form of an engagement letter," AU sec. 310 does not mandate the use of an engagement letter in an audit of financial statements.

However, auditors have long recognized the use of an engagement letter as the best way to document the understanding reached between the auditor and the client. Indeed, most audit firms' quality control policies and procedures require the use of engagement letters in connection with an audit of an issuer's financial statements.

### **Discussion Question –**

6. Should a standard on communications with audit committees mandate the use of an engagement letter?

### **Compliance with Listing Standards of the Various Stock Exchanges**

In response to Section 301 of the Act, the SEC proposed in January 2003 Rule 10A(3), which requires each self-regulatory organizations ("SROs"), such as the national securities exchange and national securities association, to prohibit the listing of any security of an issuer not in compliance with the audit committee requirements

specified in Rule 10A-3. Appendix B presents a brief summary of an audit committee's duties and responsibilities pursuant to Rule 10A-3.

The SEC regulations represent the minimum standards for rules to be adopted by SROs. Accordingly, the SROs adopted listing requirements to comply with Rule 10A-3. Some SROs, however, have adopted more stringent requirements than those prescribed by the SEC's Rule 10A-3.

*New York Stock Exchange ("NYSE") Listing Standards.* Section 303A.07 of the listing standards of the NYSE require an issuer's audit committee to have, among other things, a written charter that addresses: (1) the committee's purpose, (2) an annual performance evaluation of the audit committee, and (3) the duties and responsibilities of the audit committee. In addition to complying with the duties and responsibilities enumerated in Section 10A-3, the listing standards also require an audit committee to, among other things –

- (a) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company; and
- (b) discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The SEC has approved the NYSE's new listing requirements, which indicate that listed issuers must comply with the new listing standards by the earlier of (a) the listed issuer's first annual shareholder meeting after January 15, 2004 or (b) October 31, 2004.

*National Association of Securities Dealers ("NASD") Listing Standards.* In November 2003, the SEC approved changes to Rule 4350, which governs qualitative listing requirements for Nasdaq National Market and Nasdaq Small Cap Issuers. NASD Rule 4350(d)(3) requires the audit committee to have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b). In addition,

however, Rule 4350(h) specifies that an issuer's audit committee (or comparable body of its board) must review and approve all related party transactions.

As previously discussed in earlier sections of this paper, a new standard on communications with audit committees would include auditor communications that enable the audit committee to comply with the Act. Some listing standards adopted by SROs, however, require audit committees to go beyond the requirements of the Act. In some cases, additional communications from the auditor will be necessary to enable an audit committee to comply with these more stringent requirements. For instance, an auditor must provide copies of the firm's internal quality-control procedures and its peer review report, among other things, for the audit committee to comply with NYSE item (a) above. Likewise, the auditor must discuss the financial statements, related disclosures, and management's discussion and analysis ("MD&A") with the audit committee for it to meet the requirements of NYSE item (b) in the previous section, "New York Stock Exchange Listing Standards." In addition, an auditor might be asked to communicate certain information about related party transactions to an audit committee to assist the committee in complying with NASD Rule 4350(h).

The NYSE and NASD rules are a reasonable proxy for rules that companies might have to adhere to when listing with other SROs.

### **Discussion Questions –**

7. Should a standard on communications with audit committees require an auditor to make communications to the audit committee to enable the audit committee to comply with the listing standards, even though (a) the issuer might not be a listed company, or (b) the issuer might be listed on an SRO that requires compliance only with Rule 10A-3?
8. Specifically, what additional communications (that is, communications beyond those required to enable the audit committee to comply with the requirements of the Act and Rule 10A-3) should the auditor be required to make to assist an audit committee in complying with listing standards?

### **Aggressiveness vs. Conservatism**

In 1998, the NYSE and the NASD announced the formation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. In its 1999 *Blue Ribbon Report*, the committee made a series of recommendations directed to regulators and standards-setting bodies to improve the overall performance of an audit committee in overseeing an issuer's financial reporting process. In response to the *Blue*

*Ribbon Report*, the NYSE, NASD, SEC, and the American Institute of Certified Public Accountants ("AICPA"), among others, issued new requirements.

Recommendation 8 in the *Blue Ribbon Report* dealt with the auditor's judgments about the quality of accounting principles. That recommendation stated that auditing standards should require an auditor to discuss with the audit committee his or her judgments about the quality, not just the acceptability, of a company's accounting principles as applied in its financial statements. According to the *Report*, the discussion should include issues such as the clarity of the company's financial disclosures, the degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates, and other decisions made by management in preparing the financial disclosures.

The AICPA issued SAS No. 90, *Audit Committee Communications*, specifically in response to this recommendation. SAS No. 90 amended SAS No. 61 to require an auditor to communicate to an 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. SAS No. 61, however, did not require an auditor, as part of that discussion, to discuss with the audit committee the degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates.

The AICPA explained its position in Practice Alert 2000, *Guidance for Communication with Audit Committees Regarding Alternative Treatments of Financial Information within Generally Accepted Accounting Principles*, which stated, in part –

Blue Ribbon Committee ("BRC") Recommendation No. 8 suggests that the auditor's communication with the audit committee should address the degree of aggressiveness or conservatism of the accounting principles applied in the financial statements. The concept of aggressiveness or conservatism was viewed by many as too ambiguous to be dealt with effectively in response to the BRC recommendation. As a result, the amendment to SAS No. 61 that requires the auditor to discuss quality with the audit committee... addresses the BRC recommendation by requiring a discussion of items that have a significant impact on representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements as those terms are defined in CON 2. Accordingly, a discussion of aggressiveness or conservatism is not required. ...

Conservatism may be defined as prudent reaction to try to ensure that uncertainty and risks inherent in business situations are adequately considered.<sup>5/</sup> The term today is often misunderstood and has sometimes been used to defend accounting judgments that may not be fully supportable. As a result, the crossover between what is conservative and what is aggressive sometimes is difficult to distinguish. In the current financial reporting environment, actions that are conservative to one person may be viewed as aggressive by another. An entity that provides reserves for losses based on an overly pessimistic view (and thus may have excess reserves that can be released into earnings in future periods) may be viewed as aggressive in the current reporting environment notwithstanding past experiences of companies being viewed as aggressive for failing to provide adequate reserves. Providing for losses on a "too much, too soon" basis is as erroneous as providing for losses "too little, too late." Conservatism in financial reporting should not be used to justify understatement of income or assets.

However, conservatism is an intrinsic accounting concept that auditors understand. Likewise, auditors understand the concept of aggressiveness in financial reporting. Despite the difficulty that might exist in defining these terms in a standard, most auditors "know them when they see them."

#### **Discussion Questions –**

9. In connection with an auditor's views of the quality of an issuer's accounting policies, is it sufficient to require the auditor to discuss with the audit committee items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements?
10. If not, should an auditor be required to discuss with the audit committee the degree of aggressiveness or conservatism of the accounting principles applied in the financial statements? Should these or other terms be used to describe the range of management's judgments?

#### **SAS No. 61 Communications No Longer Necessary**

As previously discussed in the section titled "Existing Auditing Standards on Communications with Audit Committees," SAS No. 61 requires an auditor to make a

---

<sup>5/</sup> This definition is from FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

host of communications to an audit committee in connection with a financial statement audit. This briefing paper describes a number of new communication requirements for which an auditor might be responsible.

In light of the new items being considered, some items previously required by SAS No. 61 might no longer be considered beneficial to an audit committee.

### **Discussion Question –**

11. Are any communication requirements in SAS No. 61 no longer considered necessary?

### **Broader Communication Responsibilities**

This briefing paper discusses a number of specific matters an auditor might communicate to an issuer's audit committee. Some of these matters currently are included in existing auditing standards, while others are being considered for inclusion in a new standard on auditor communications. Despite these specific communication requirements, however, there are some questions about whether an auditor should have a broader responsibility for communications with audit committees.

Because of an auditor's unique perspective on an issuer's financial reporting process, the auditor possesses a myriad of information that might be valuable to an audit committee in fulfilling its financial oversight responsibilities. Therefore, a new auditing standard might require an auditor to engage in discussions with an audit committee about the *overall quality* of the financial statements as seen through the eyes of the auditor, similar to the type of discussions management includes in the MD&A section of the issuer's annual report. Thus, the purpose of the auditor's discussion about the overall quality of the financial statements and related disclosures might be to provide the audit committee with a more in-depth understanding of the results of the issuer's financial reporting process.

A broader communication responsibility also might involve requiring discussions with the audit committee about matters beyond those encompassed in the financial statements and related disclosures. For instance, an issuer's financial reporting process also provides other financial information that management publishes in its annual report. Such financial information might be used in a 10-year summary of financial results or in MD&A. Existing auditing standards require an auditor to read such information and consider whether it, or the manner of its presentation, is materially inconsistent with information appearing in the audited financial statements. Existing standards also require the auditor to discuss with the audit committee his or her responsibility for the

information, the procedures performed, and the results of such procedures. They do not, however, require the auditor to discuss with the audit committee his or her views on the quality of that information. Such a discussion might become increasingly important to an audit committee in light of its additional oversight responsibilities in these areas. (As previously discussed, the NYSE rules require an issuer's audit committee to review MD&A.)

Finally, this broader communication responsibility also might involve requiring an auditor to discuss with an audit committee his or her views about the fair presentation of information contained in an issuer's earnings release. SAG agenda item 8, "Potential Project – Auditor's Responsibility for Communications to Investors Containing Financial Information," provides further discussion of the issues surrounding an auditor's responsibility for an earnings release and for other information contained in an annual report.

#### **Discussion Questions –**

12. Should an auditor have a broader responsibility for communicating with an issuer's audit committee his or her views about the *overall quality* of the financial statements and related disclosures? If so, what communications in addition to those already discussed in this document should the auditor be required to make to an audit committee?
13. Should an auditor have a broader responsibility for communicating with an issuer's audit committee his or her views about the quality of other financial information included in a document that also includes the financial statements and related disclosures? If so, what additional communication responsibilities should the auditor assume?
14. Should an auditor have a responsibility for communicating to an audit committee his or her views about the fair presentation of an issuer's earnings release?

## **APPENDIX A**

### **Communications with Audit Committees Required by Other Auditing Standards**

#### **Illegal Acts**

A1. SAS No. 54, *Illegal Acts by Clients* (AU sec. 317), requires the auditor to inform the audit committee about illegal acts that come to his or her attention. The term *illegal acts*, for purposes of AU sec. 317, refers to violations of laws or governmental regulations.

#### **Fraud**

A2. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316), defines *fraud* as an intentional act that results in a material misstatement in financial statements that are the subject of an audit. AU sec. 316 requires the auditor to communicate to the audit committee evidence of fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, it requires the auditor to reach an understanding with the audit committee regarding the nature and extent of communications about fraud perpetrated by lower-level employees.

#### **Noncompliance with Laws and Regulations for Governmental Entities**

A3. SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU sec. 801), establishes the auditor's responsibility when he or she is engaged to (a) audit a governmental company under generally accepted auditing standards and (b) test and report on compliance with laws and regulations under Government Auditing Standards (the Yellow Book) or in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

A4. Existing auditing standards do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a financial statement audit the auditor becomes aware that the company is subject to an

audit requirement that might not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee that an audit in accordance with generally accepted auditing standards might not satisfy the relevant legal, regulatory, or contractual requirements. For example, the auditor will be required to make this communication if an entity engages an auditor to perform an audit of its financial statements and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with government auditing standards, the Single Audit Act of 1984 and OMB Circular A-128, OMB Circular A-133, or other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides.

### **Internal Control-Related Matters Noted During an Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements**

A5. PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of the Financial Statements* establishes requirements for an auditor engaged to perform an integrated audit (that is, an audit of both the financial statements and the effectiveness of internal control over financial reporting).

A6. *Significant Deficiencies and Material Weaknesses.* Among other things, the standard requires the auditor to communicate to the audit committee all significant deficiencies and material weaknesses that have been identified during the audit.

A7. In addition, the standard requires that the auditor communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those control deficiencies that are of a lesser magnitude than significant deficiencies) identified during the audit. It also requires the auditor to inform the audit committee when such a communication has been made.

A8. *Other Matters.* PCAOB Auditing Standard No. 2 also requires the auditor to make certain communications to the audit committee when –

- The auditor determines that management has failed to meet certain obligations under the standard (See PCAOB Auditing Standard No. 2, paragraph 21);

- Management fails to disclose or identify a material weakness in its report on the effectiveness of internal control over financial reporting (See PCAOB Auditing Standard No. 2, paragraph 176);
- The auditor believes there is a material misstatement of fact in additional information included in management's report on the effectiveness of internal control over financial reporting (See PCAOB Auditing Standard No. 2, paragraph 192);
- Management fails to respond appropriately to an auditor's communication that modifications to the issuer's disclosures about changes in internal control are necessary for them to be accurate and in compliance with Section 302 of the Act (See PCAOB Auditing Standard No. 2, paragraph 205); and
- The auditor has communicated to management, in writing, all deficiencies in internal control (not just significant deficiencies and material weaknesses) noted during the audit (See PCAOB Auditing Standard No. 2, paragraph 209);
- The auditor identifies during the course of an audit fraud perpetrated by senior management or possible illegal acts (See Auditing Standard No. 2, paragraph 213).

A9. SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AU sec. 325), requires the auditor to communicate in writing to management and the audit committee all reportable conditions identified during an audit of financial statements.<sup>6/</sup>

### **Review of Interim Financial Information**

A11. The Securities and Exchange Commission ("SEC") requires<sup>7/</sup> a company to engage an independent accountant to review the company's interim financial

---

<sup>6/</sup> AU sec. 325 uses the term *reportable conditions*. As discussed in the briefing paper, the Board has proposed an amendment that would conform this terminology to that used in PCAOB Auditing Standard No. 2 (that is, significant deficiencies and material weaknesses).

<sup>7/</sup> This requirement is set forth in Rule 10-01(d) of Regulation S-X for Form 10Q and Item 3-10(b) of Regulation S-B for Form 10QSB.

information in accordance with AU sec. 722, *Interim Financial Information*, before the registrant files its quarterly report on Form 10-Q or Form 10-QSB. AU sec. 722 does not require an accountant to issue a written report on such a review. However, the SEC requires that an accountant's review report be filed with the interim financial information if, in any filing, the company states that the interim financial information has been reviewed by an independent public accountant.

A12. AU sec. 722 requires the accountant to communicate certain matters to an audit committee when –

- Management fails to respond appropriately to the accountant's communication that he or she believes (a) material modification should be made to the interim financial information for it to conform with generally accepted accounting principles or (b) that the company filed the Form 10-Q or Form 10-QSB before the completion of the review;
- The accountant identifies during the review fraud perpetrated by senior management or possible illegal acts; and
- The accountant encounters during the review other matters that relate to the interim review. (For example, the accountant should determine that the audit committee is informed about the process used by management to formulate particularly sensitive accounting estimates; about a change in a significant accounting policy affecting the interim financial information; about adjustments that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and about uncorrected misstatements aggregated by the accountant that were determined by management to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole.)

A13. The accountant should attempt to discuss such matters with the audit committee before the company files its interim financial information with a regulatory agency (such as the SEC). If such communications cannot be made before the filing, they should be made as soon as practicable in the circumstances. The communications may be oral or written. If information is communicated orally, the accountant should document the communications.

---

## **APPENDIX B**

### ***Listing Standards Relating to Audit Committees***

B1. This appendix provides a brief summary of the required standards relating to audit committees in Rule 10A-3(a) and (b) of the Securities and Exchange Act of 1934. For the complete rules, see “Final Rule: Standards Relating to Listed Company Audit Committees,” Securities and Exchange Commission Release No. 33-8220 (April 9, 2003).

(a) Rule requires the rules of each national securities exchange and national securities association to prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of paragraph (b) or (c) of this section.

(b) Required standards –

- (1) Independence. Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent.
- (2) Responsibilities relating to registered public accounting firms. The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.
- (3) Complaints. Each audit committee must establish procedures for handling complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters, as well as for confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.

- (4) Authority to engage advisers. Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.
  - (5) Funding. Each listed issuer must provide for appropriate funding for payment of compensation to any registered public accounting firm or other advisers employed by the committee, as well as to fund ordinary administrative expenses of the audit committee.
- (c) Provides general exemptions for the rules.