
STANDING ADVISORY GROUP MEETING

PANEL DISCUSSION – COMMUNICATIONS WITH AUDIT COMMITTEES

OCTOBER 5-6, 2005

Introduction

The Board's interim auditing and related professional practice standards^{1/} include pre-existing requirements governing an auditor's communications with a company's audit committee. These requirements pre-date the Sarbanes-Oxley Act of 2002 ("the Act") and are principally described in AU sec. 380, *Communication with Audit Committees*. With the passage of the Act, along with the SEC's related implementation rules, the role of the audit committee has been strengthened in overseeing a company's financial reporting process. Specifically –

- Section 202 of the Act requires an issuer's audit committee to pre-approve all services to be provided by its auditor.
- Section 204 of the Act requires auditors to communicate to audit committees all critical accounting policies and practices; all alternative treatments of financial information within generally accepted accounting

^{1/} On April 16, 2003, the Board adopted certain pre-existing standards as its interim standards to be used on an initial, transitional basis. PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T describe the standards that the Board adopted and require registered public accounting firms and their associated persons to comply with these interim standards to the extent not superseded or amended by the Board. See the interim standards at www.pcaob.org/standards.

This paper was developed by the staff of the Office of the Chief Auditor 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.

STANDING ADVISORY GROUP MEETING

principles that have been discussed with management; and other material written communications between the auditor and management, such as any management letter or schedule of unadjusted differences.

- Section 301 of the Act requires an issuer's audit committee to be directly responsible for the appointment, compensation, and oversight of the work of any registered firm employed by the issuer for the purpose of preparing or issuing an audit report or related work.

Appendix A describes the communications required of the auditor by PCAOB standards and the Act.

The Board is evaluating its interim standards to determine whether additional communication requirements should be added and whether any of the existing requirements should be eliminated. For example, as a part of every audit the auditor must assess the risk that the financial statements are materially misstated due to fraud or otherwise. The Board's interim auditing standards do not require the auditor to communicate the results of this assessment. The Board is seeking advice as to whether knowledge of this assessment could help audit committees in overseeing the auditor's work.

The SAG will hear brief presentations from a panel of individuals who serve on audit committees. The SAG then will have the opportunity to ask questions of the panelists.

Discussion Topics –

Presentations and discussion may address the following matters –

- How often, when, and why, audit committees meet with auditors during the year, and whether management officials attend any of these meetings.
- Examples of approaches or procedures employed by auditors or audit committees that improve the quality of communication between the auditor and the audit committee.

STANDING ADVISORY GROUP MEETING

- Examples of written and oral communications from auditors to audit committees that improve the quality of communication between the auditor and the audit committee.
- Examples of matters arising in connection with interim period reviews that auditors should communicate to audit committees.
- Examples of forms of communications from auditors to audit committees regarding anticipated audit and non – audit services to be performed, and whether those communications occur pursuant to audit committee policies and procedures for pre-approving auditors' services or otherwise.
- How information communicated by auditors can best be organized, so as not to overload audit committees with time-consuming review of immaterial information.
- Whether receiving the following information would assist audit committees in their oversight of auditors' work –
 - The auditor's assessment of the risks of material misstatement due to fraud (as opposed to the audit committee's understanding of the issuer's assessments of the risks of fraud and the programs and controls established to mitigate those risks, pursuant to AU 316.22);
 - Identified related parties and other persons and companies that have special relationships with the issuer, and transactions with those related parties and other persons and companies;
 - The nature and scope of proposed audit and non-audit services and related fees;
 - If applicable, disclosure of the information that led the auditor to believe there could be substantial doubt about the company's ability to continue as a going concern.

STANDING ADVISORY GROUP MEETING

- Suggestions on additional matters that auditors should communicate to audit committees to improve the effectiveness of audit committees' oversight of auditors' work and/or the quality of financial reporting.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

STANDING ADVISORY GROUP MEETING

APPENDIX A

Communications Required by Current Standards and Rules

This appendix briefly summarizes the communications to audit committees required by PCAOB standards^{1/} and the Act.

Certain Matters to be Communicated In Connection with an Audit

AU sec. 380, *Communication with Audit Committees*, requires the auditor to communicate to the audit committee certain information about the following matters –

- The auditor's responsibility under standards of the PCAOB
- Significant accounting policies and unusual transactions
- Management's judgments and accounting estimates
- Audit adjustments
- Auditors' judgments about the quality of the issuer's accounting principles
- Other information in documents containing audited financial statements
- Disagreements with management
- Consultation with other accountants
- Major issues discussed with management prior to retention
- Difficulties encountered in performing the audit

^{1/} Auditing standards included herein include the pre-existing interim auditing standards adopted by the PCAOB, as of April 16, 2003, as amended by the Board, as well as standards issued by the PCAOB since its inception.

STANDING ADVISORY GROUP MEETING

In addition, the Act imposes the following requirements –

- Under Section 204, an auditor must communicate 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 issuer.
- Under Section 301, the audit committee of a listed issuer is responsible for the appointment, compensation, retention, and oversight of the work of a registered public accounting firm employed by the issuer for the purpose of preparing or issuing an audit report or related work, and the auditor must report directly to the audit committee.

Auditor Independence

Independence Standards Board^{2/} Statement No. 1, *Independence Discussions with Audit Committees*, requires the auditor, on at least an annual basis, to (a) disclose to the audit committee, in writing, any relationship with the company that, in the auditor's judgment, might reasonably be thought to bear on independence; (b) confirm in a letter to the audit committee that the firm is independent; and (c) discuss the auditor's independence with the audit committee.

Sections 201 and 202 of the Act require an issuer's audit committee to pre-approve all services to be provided by the issuer's auditor (including any non – audit services that are not prohibited).

^{2/} The Independence Standards Board ("ISB") came into existence in 1997 based on an agreement between the SEC and the accounting profession (i.e., the AICPA). Its mission was to set independence standards for auditors of public companies. However, with the SEC issuing a dramatic revision to its independence rules in 2000, there was no apparent need for the ISB to continue its work. Thus, the ISB ceased operations in July 2001.

STANDING ADVISORY GROUP MEETING

Illegal Acts and Fraud

Under AU sec. 317, *Illegal Acts by Clients*, an auditor should assure himself that an issuer's audit committee is adequately informed about illegal acts^{3/} that come to the auditor's attention, unless such acts are clearly inconsequential. Under this standard, an auditor may reach agreement with the audit committee on the nature of matters to be communicated to the audit committee in advance, but in any event such communication should describe the act, the circumstances of its occurrence, and the effect on the financial statements.

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to make inquiries directly of the audit committee (or at least its chair) about its views on the risks of fraud and whether it has knowledge of any fraud or suspected fraud affecting the entity. AU sec. 316 also requires the auditor to obtain an understanding of how the audit committee exercises oversight of the audit client's assessment of the risks of fraud and the programs and controls the audit client has established to mitigate these risks. In addition, AU sec. 316 requires the auditor to communicate to the audit committee, among other matters, fraud involving senior management and fraud, whether caused by senior management or other employees, that causes a material misstatement of the financial statements.

Section 10A of the Securities and Exchange Act of 1934 requires an auditor who, in the course of an audit of an issuer's financial statements, detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred to determine that the audit committee is adequately informed as soon as practicable, unless the illegal act is clearly inconsequential.

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

In connection with an audit performed pursuant to PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of the Financial Statements*, an auditor must communicate in writing to management and the audit committee all significant deficiencies and material

^{3/} AU 317 defines the term *illegal act* as a violation of law or governmental regulation.

STANDING ADVISORY GROUP MEETING

weaknesses that the auditor identifies in the company's internal control over financial reporting and other internal control-related matters.

Internal Control-Related Matters Identified During an Audit of Financial Statements

Under AU section 325, as amended by Auditing Standard No., 2, the auditor must communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit of the financial statements.

Reporting on a Previously Reported Material Weakness

Under PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*,^{4/} if the auditor determines that a material weakness still exists but does not issue a report, then the auditor is required to communicate, in writing, to the audit committee the auditor's conclusion that the material weakness continues to exist. Similarly, if the auditor identifies, during an engagement pursuant to PCAOB Auditing Standard No. 4, a material weakness that has not been previously communicated to the audit committee in writing, the auditor is required to communicate that material weakness, in writing, to the audit committee.

Review of Interim Financial Information

Under AU sec. 722, *Interim Financial Information*, if the auditor believes that material modification should be made to interim financial information for it to conform with GAAP, and management has not responded appropriately, the auditor is required to inform the audit committee as soon as practicable.

^{4/} PCAOB Auditing Standard No. 4 was adopted by the Board on July 26, 2005, and will not become effective unless approved by the SEC.