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Public Company Accounting Oversight Board

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STANDING ADVISORY GROUP MEETING

COMMUNICATIONS WITH AUDIT COMMITTEES

October 14-15, 2009

Introduction

The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is evaluating its auditing standard on audit committee communications, AU sec. 380, *Communication with Audit Committees* ("AU sec. 380").[1/] As part of this evaluation, the Board is reviewing the possibility of amending AU sec. 380 or developing a new standard on communications with audit committees that would supersede the Board's current standard.

The staff believes that a standards-setting project to revise its standard on communications with audit committees may be appropriate for a number of reasons. First, Standing Advisory Group ("SAG") members have previously commented that communications with audit committees could be enhanced to provide greater information about the audit. The staff believes it is appropriate to consider any additional requirements that may enhance effective, two-way communications between auditors and audit committees. Second, the staff believes it may be appropriate to enhance the requirements to provide for greater communication about management's judgments and estimates. Finally, a standards-setting project in this area could clarify and consolidate the current guidance into a single standard, as well as consider the work of other standards-setters and additional input from the SAG.

[1/] References to AU sections ("AU secs.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement on Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's Web site at www.pcaobus.org.

The SAG discussed the topic of communications with audit committees at its June 21, 2004[2/] and October 5, 2005[3/] meetings. The discussion topics at the June 21, 2004 meeting included:

- Whether communications to the audit committee should be in writing;
- Whether a standard should prescribe the timing of when such communications should be made;
- Whether to require written engagement letters;
- Whether to incorporate certain communication requirements imposed by various self-regulatory organizations, such as the New York Stock Exchange ("NYSE") and NASDAQ Stock Market LLC ("NASDAQ"), into an auditing standard;
- Whether the auditing standard should require auditors to indicate whether management's financial reporting is aggressive or conservative; and
- Whether there are any existing communication requirements that are no longer necessary.

At the October 5, 2005 SAG meeting, a panel discussed similar topics relating to communications with audit committees. Additionally, SAG members have commented on audit committee communication requirements during SAG discussions on other topics, such as going concern and audit quality indicators.[4/] We are seeking additional information from the SAG at the October 14-15, 2009 meeting to enhance our understanding of key issues before the Board considers proposing a new standard.

[2/] See briefing paper for the June 21, 2004 SAG discussion at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/06-21/Agenda%20item%2010.pdf.

[3/] See briefing paper for the October 5, 2005 SAG discussion at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2005/10-05-06/Audit_Committee_Panel.pdf.

[4/] The SAG discussed going concern matters at its April 1, 2009 meeting and audit quality indicators at its October 23, 2008 meeting. See http://www.pcaobus.org/Standards/Standing_Advisory_Group/index.aspx for the respective agendas.

This briefing paper provides SAG members with background information on the roles and responsibilities of audit committees in overseeing auditors as well as the auditor's responsibility to communicate with the audit committee. The paper also provides information about five discussion topics and related discussion questions: (1) effective, robust two-way communications, (2) enhance the existing communication requirement related to management's judgments and estimates, (3) additional requirements for discussion of disclosures, (4) interim financial information, and (5) information on firm and engagement leadership.

Roles and Responsibilities of Audit Committees in Overseeing Auditors

Audit committees play a key role in corporate governance and assume numerous oversight responsibilities. The Sarbanes Oxley Act of 2002 (the "Act"), along with the U.S. Securities and Exchange Commission’s ("SEC") related implementation rules, broadened the role of the audit committee to include overseeing a company's financial reporting process. Congress and the SEC have established specific requirements for exchanges to impose on audit committees of all listed companies. These requirements specify that the audit committee is to be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm employed by the issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm must report directly to the audit committee.[5/]

The SEC also requires the audit committee to include a statement in the proxy statement[6/] that it has:

- Discussed the audited financial statements with management;

- Discussed with the auditors the matters required by Statement on Auditing Standards ("SAS") No. 61, as amended (AICPA,

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5/ See Section 301 of the Sarbanes-Oxley Act of 2002 and Section 10A(m)(2) of the Securities Exchange Act of 1934; SEC Exchange Act Rule 10A-3(b)(2); and 17 C.F.R. 240.10A-3(b)(2).

6/ Companies must provide this statement only in a proxy statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). Audit committees of foreign private issuers, which are not subject to the proxy statement requirement, are not required to provide this statement in the Annual Reports on Form 20-F.

Professional Standards, Vol. 1 AU sec. 380 [as adopted by the PCAOB in Rule 3200T]*;*

- Received from and discussed with the auditors the written disclosures and the letter from the auditors required by the PCAOB concerning the auditor's independence; and

- Recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.[7/]

In addition to the SEC rules, audit committees can be subject to rules established by the respective exchanges on which the company is traded. The NYSE, e.g., has imposed responsibilities for audit committees.[8/] Section 303A.07 of the listing standards of the NYSE requires 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.[9/]

Auditor Responsibilities to Communicate with the Audit Committee

The Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA") issued SAS No. 61, *Communication With Audit Committees*, in the late 1980's. That standard required an auditor to communicate certain matters to a company's audit committee or equivalent group. Subsequently, the communication requirements of SAS No. 61 were refined by the ASB with the issuance of SAS No. 89, *Audit Adjustments*, and SAS No. 90, *Audit Committee Communications* which were codified by the AICPA as AU sec. 380. The PCAOB adopted AU sec. 380 in 2003 as part of its interim standards. AU sec. 380[10/] contains the following required communications by the auditor with the audit committee:

[7/] See item 407(d) of Regulation SK.

[8/] The Section 303A.07 requirements are available at: http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F.

[9/] Ibid.

[10/] See AU secs. 380.06-16.

- *Auditor's responsibility* – The auditor should communicate the level of responsibility assumed for an audit of internal control and/or financial statements under PCAOB standards;

- *Significant accounting policies* – The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application as well as the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;

- *Management judgments and accounting estimates* – The auditor should determine that the audit committee is informed about management's process for formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates;

- *Audit adjustments* – The auditor should inform the audit committee about adjustments arising from the audit that could, either individually or in the aggregate, have a significant effect on the entity's financial reporting process and about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole;

- *Auditor's judgments about the quality of the entity's accounting principles* – The auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles;

- *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 the auditor's report;

- *Consultation with other accountants* – When the auditor is aware that management has consulted with other accountants about auditing and accounting matters, the auditor should discuss his or her views about significant matters that were the subject of such consultation;

- *Major issues discussed with management prior to retention* – The auditor should discuss any major issues that were discussed with management in connection with the initial or recurring retention of the auditor, including, among other matters, any discussion regarding the application of accounting principles and auditing standards; and

- *Difficulties encountered in performing the* audit – The auditor should inform the audit committee of any serious difficulties encountered in dealing with management related to the performance of the audit.

Additionally, PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, requires the communication in writing of all material weaknesses and significant deficiencies identified during the audit. Moreover, other PCAOB standards and rules require communication of specific matters.[11/]

The Act and rules of the SEC also require auditors to communicate certain information to the audit committee. Those required communications include:

- All critical accounting policies and practices to be used;

- 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

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[11/] Other PCAOB standards and rules specifically include AU sec. 310, *Appointment of the Independent Auditor*; AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; AU sec. 317, *Illegal Acts by Clients*; AU sec. 325, *Communications about Control Deficiencies in an Audit of Financial Statements*; AU sec. 722, *Interim Financial Information*; AU sec. 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance;* Rule 3524*, Audit Committee Pre-approval of Certain Tax Services;* Rule 3525*, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting;* and Rule 3526*, Communication with Audit Committees Concerning Independence.*

alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

- Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.[12/]

In addition, the Act and the SEC independence rules require the auditor to seek pre-approval of all audit and non-audit services before the firm is engaged by the issuer to perform those services.[13/]

In recent years, The International Auditing and Assurance Standards Board ("IAASB") issued International Standard on Auditing 260, *Communication with Those Charged with Governance* ("ISA 260"), and the ASB issued SAS No. 114, *The Auditor's Communication with Those Charged with Governance*. The staff will consider the work of these standards-setters, as well as input from the SAG and others, as part of any standards-setting project on communications with audit committees.

Discussion Topics

Effective, Robust Two-way Communications

A well-informed audit committee is important in establishing successful corporate governance. As discussed, AU sec. 380 was originally developed in the late 1980's when the auditors were typically hired and retained by management and prior to the audit committee being responsible for the compensation and oversight of the auditor.

Academic research has shown that "[f]requent communications with a well-informed, financially sophisticated audit committee and communications among the audit committee, the auditor and the full board improve financial reporting quality."[14/] At previous SAG meeting discussions, some SAG members have expressed concern that auditor communications do not always provide

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12/ See section 204 of the Sarbanes-Oxley Act of 2002, section 10A(k) of the Securities Exchange Act or 1934, and17 C.F.R. Section 210.2-07.

13/ See sections 201 and 202 of the Sarbanes-Oxley Act of 2002; sections 10A(g), (h) and (i) of the Securities Exchange Act of 1934; and 17 C.F.R. Section 210.2-01(c)(7).

14/ "Auditor Communications with the Audit Committee and Board: Policy Recommendations and Opportunities for Future Research," *Accounting Horizons* (June 2007).

audit committees with the information they need. Additionally, concerns have been expressed that communications are sometimes "boilerplate" in nature. In prior SAG meetings, some SAG members have commented that audit committee communications should be more robust. In order to increase the effectiveness of the auditor's communications, the Board may consider adding requirements regarding the timing and form, whether written or oral, of communications to the audit committee.

The Board's current standard provides guidance for auditor communications with audit committees. Although the Board can encourage effective, robust two-way communications, successful communication depends on the candor and vigor with which auditors comply with the PCAOB standards, and the extent of the audit committee's engagement.

Discussion Questions –

1. Are there any structural or cultural impediments to audit committees obtaining the information they need to fulfill their responsibilities to oversee the work of the auditor?

2. Given the previous comments raised by SAG members that the auditor communications are sometimes boilerplate in nature and not robust enough, in what way can audit committee communications be improved?

3. What should the Board consider including in the auditing standard to encourage more effective, robust auditor communications?

Enhance the Existing Communication Requirement Related to Management's Judgments and Estimates

AU sec. 380 requires the auditor to communicate a number of matters to the audit committee, e.g., communications about management's judgments and accounting estimates. While the existing standard addresses management's judgments and accounting estimates, it does not include a requirement for the auditor to communicate his or her assessment about management's judgments, inputs significant to those judgments, and the quality of the related disclosures. Rather, the existing requirement directs the auditor to determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments.[15/] The susceptibility of management's judgments and estimates to misstatements due to their complex nature would seem supportive of the audit committee receiving more information from the auditor in this area.[16/] The Board may consider enhancing this requirement to include, among other things, a discussion by the auditor of his or her consideration of potential management bias in determining accounting estimates and judgments, the auditor's evaluation of the reasonableness of management's assumptions and methodology and related disclosures, and a comparison of the assumptions to those used in prior years.

Discussion Questions –

4. Should the required communication regarding management's judgments and estimates be enhanced to report additional information on management's judgments and estimates? If so, what information would be useful to audit committees?

5. The current standard requires the auditor to "determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates."[17/] Should the requirement apply more broadly to all significant accounting estimates and judgments?[18/]

15/ See AU sec. 380.08.

16/ "Effective communications which contribute to financial reporting quality should include discussions of areas more susceptible to earnings management (e.g., discretionary accruals) and factors that might drive managers to make aggressive accounting choices (e.g., analyst forecasts and other performance measures)" – "Auditor Communications with the Audit Committee and Board: Policy Recommendations and Opportunities for Future Research," *Accounting Horizons* (June 2007).

17/ See AU sec. 380.08.

18/ As defined in Auditing Standard No. 5, paragraph A10, an account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

Additional Requirements for Discussion of Disclosures

Financial statement disclosures are an integral part of the financial statements and play an increasingly important role in financial reporting, as evidenced by recent additional disclosure requirements on fair value measurements, among other things.[19/] Currently, there are no specific communication requirements for the auditor to discuss the auditor's assessment of the quality and adequacy of disclosures. PCAOB AU sec. 431, *Adequacy of Disclosure in Financial Statements*, requires that the auditor consider whether the presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters and whether there are particular matters that should be disclosed in light of the circumstances and facts of which he is aware at the time.[20/]

The Board is interested in whether the auditor should be required to have a specific discussion with the audit committee about the auditor's assessment of the quality and adequacy of financial statement disclosures.

Discussion Question –

6. Should the auditor be required to discuss his or her assessment of the quality of disclosures in the financial statements with the audit committee?

Interim Financial Information

The objective of a review of interim financial information under, AU sec. 722, *Interim Financial Information,* is to provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally

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[19/] For example, see (1) FASB Accounting Standards Codification ("FASB Codification") Topic 820, *Fair Value Measurements and Disclosures*, section 820-10-65, formerly known as FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*; (2) FASB Codification Topic 320, section 320-10-65, formerly known as FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other*-Than-Temporary Impairments); and (3) FASB Codification Topic 825, section 825-10-65, formerly known as FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*.

[20/] See AU sec. 431.02.

accepted accounting principles. The objective of a review of interim financial information differs significantly from the objective of an audit. A review consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.[21/]

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause the accountant to believe that –

- Material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

- Modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

- The entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter to the appropriate level of management as soon as practicable. If, in the accountant's judgment, management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should inform the audit committee or others with equivalent authority and responsibility of the matters as soon as practicable.[22/]

AU sec. 722 does not require the accountant to issue a review report. If a review report is issued, the accountant's report should include a statement about whether the accountant is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[23/]

As part of the interim procedures, AU sec. 722 also requires the accountant to determine whether any of the matters described in AU sec. 380, as

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21/ See AU sec. 722.07.

22/ See AU sec. 722.29-30.

23/ See AU sec. 722.37.

they relate to the interim financial information, have been identified when conducting the interim review of financial information. If matters are identified, the accountant should communicate them to the audit committee or be satisfied that these matters have been communicated to the audit committee by management.[24/]

In consideration of the importance shareholders place on interim financial statements, the Board is considering whether the audit committee communications currently required by AU sec. 722 provide enough information to audit committees.

Discussion Question –

7. Are the current audit committee communication requirements for interim reviews effective? What additional communication requirements would be beneficial to audit committees?

Information on Firm and Engagement Leadership

The Act and SEC rules require the exchanges to require the audit committee to appoint, compensate, retain and provide oversight over the auditor's work.[25/] Prior to the appointment of the auditor, audit committees often require auditors to provide certain information about the firm and the firm's internal quality control systems along with their proposals. In addition, for issuers listed on the NYSE, the NYSE requires audit committees to, at least annually, among other things:

- Obtain and review a report by the independent auditor describing the firm's internal quality-control procedures; and
- Discuss 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

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[24/] See AU sec. 722.34.

[25/] Section 301 of the Sarbanes-Oxley Act of 2002 and Section 10A(m)(2) of the Securities Exchange Act of 1934; SEC Exchange Act Rule 10A-3(b)(2); and 17 C.F.R. 240.10A-3(b)(2).

audits carried out by the firm, and any steps taken to deal with any such issues.[26/]

The IAASB included a requirement in ISA 260 for auditors to communicate the related safeguards that have been applied to eliminate identified threats to independence which may include safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.[27/]

Other information relating to firm and engagement leadership includes:

- Engagement-level and firm-level efforts to assure compliance with SEC and PCAOB auditor independence rules and principles.
- Significant litigation against the audit firm or disciplinary actions against the firm or the engagement partner.
- Engagement leadership and the reason for changes, if any.

Discussion Question –

8. Should the Board consider requiring the auditor to provide information about the firm and the engagement leadership that would assist the audit committee in overseeing the auditor? If so, what type of information would be beneficial to audit committees?

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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.

[26/] The Section 303A.07 is available at: http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F.

[27/] See ISA 260, paragraph 17(b)(ii) and A22(b).