

To the Point

PCAOB – proposed standard

PCAOB seeks comment on expanded audit committee communications

The PCAOB is trying to enhance the relevance and effectiveness of communications between auditors and audit committees.

What you need to know

- ▶ The PCAOB proposed a new standard that would require auditors to modify and expand their communications with audit committees.
- ▶ Audit committee members should consider providing comments to the PCAOB to help focus the proposed requirements on communications they consider relevant to fulfilling their responsibility to oversee the company's external audit function, financial statements and financial reporting process.
- ▶ Comments are due by 29 February 2012.

Overview

The Public Company Accounting Oversight Board (PCAOB) proposed a standard¹ that would require auditors to modify and expand their communications with audit committees beyond what the PCAOB and the Securities and Exchange Commission (SEC) currently require.

The proposal takes into account feedback the PCAOB received on its initial 2010 proposal on audit committee communications. Like the earlier proposal, the December 2011 proposal is intended to enhance the relevance and effectiveness of communication between the auditor and the audit committee and to emphasize the importance of two-way communication.

The PCAOB is also proposing that any new requirements apply to auditors of brokers and dealers when the SEC adopts its proposal to give the PCAOB oversight of these entities.

Key considerations

In addition to maintaining many of the requirements in current PCAOB standards and SEC rules, the proposed standard would require auditors to do the following:

- ▶ Provide the engagement letter to the audit committee annually and determine that the audit committee has acknowledged and agreed to the terms. (A new engagement letter would not have to be prepared annually.)
- ▶ Ask the audit committee about matters relevant to the audit. This would expand the current requirement to ask about the committee's knowledge of actual, suspected or alleged fraud. The additional inquiries would include, for example, the audit committee's knowledge of violations or possible violations of laws or regulations or concerns raised about financial reporting matters.
- ▶ Provide more information about the audit strategy, including significant risks identified as a result of the auditor's risk assessment and the timing of the audit. This would include information about the extent and nature of specialized skills or knowledge needed, the extent to which the auditor plans to rely on the work of internal audit (or others) and the planned involvement of other firms in the audit, including affiliated firms. The auditor also would be required to communicate any significant changes in the audit strategy or significant risks identified and the reasons for the changes.
- ▶ Communicate the significant assumptions used by management in making critical accounting estimates that have a high degree of subjectivity, along with the auditor's conclusions about the reasonableness of these estimates. These communications would include any significant changes in management's process or significant assumptions, the reasons for any changes and the effect on the financial statements. Management could communicate this information as well as certain previously required communications related to significant accounting policies and practices, critical accounting policies and practices and critical accounting estimates, as long as the auditor does all of the following:
 - ▶ Participates in management's discussion with the audit committee
 - ▶ Confirms to the audit committee that management adequately communicated these matters
 - ▶ Identifies accounting practices and policies the auditor considers critical
 - ▶ Communicates any omitted or inadequately described matters
- ▶ Provide more detailed communications on the quality of the company's financial reporting, including:
 - ▶ Situations where the auditor identifies bias in management's judgments related to accounting estimates
 - ▶ The auditor's considerations of the form, arrangement and content of the financial statements and accompanying notes, including matters such as the terminology used, the amount of detail given, the classification of items and the bases of amounts disclosed
 - ▶ The auditor's concern about management's anticipated application of a new accounting pronouncement that has been issued, but is not yet effective

Some of the proposed communications would require the auditor to provide more detailed information than audit committees may want.

- ▶ Communicate matters that are difficult or contentious for which the auditor consulted with anyone outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process
- ▶ Communicate any significant transactions of which the auditor is aware that are outside the normal course of business or that otherwise appear unusual, including the auditor's understanding of the business rationale for such transactions
- ▶ Communicate the conditions and events the auditor identified that, when considered in the aggregate, indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. If that doubt is mitigated, additional communications would be necessary about management plans that mitigated the auditor's doubt. The PCAOB appears to want the auditor to give the audit committee an "early warning," even if the auditor's doubt is subsequently mitigated
- ▶ Discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that any uncorrected misstatements were immaterial, including the qualitative factors considered and the effect uncorrected misstatements may have on future-period financial statements
- ▶ Discuss with the audit committee the implications on the company's financial reporting process of corrected misstatements that might not have been detected except through the auditing procedures performed

How we see it

We support enhancing communication with audit committees and providing additional information to help audit committees fulfill their oversight responsibilities. At the same time, we have some concerns about certain details in the proposal. For example, certain of the proposed communications would require the auditor to provide information that is at a level of detail that may be more granular than some audit committees want (and may take focus away from more important matters).

Other matters

The proposed communications could be written or oral (except for communications that are required to be written).

For non-issuers that don't have audit committees or boards, the proposal would apply to communications with people designated to oversee the accounting and financial reporting processes and audits of the financial statements.

The standard would be effective for 2013 audits.

Next steps

We encourage audit committee members to evaluate the effect the expanded communications might have on their ability to fulfill their oversight responsibilities and provide comments to the PCAOB.

Audit committee members may want to consider the following questions:

- ▶ Do you believe you are currently receiving the appropriate level of communications from your auditor? If not, what additional items do you believe should be communicated?
- ▶ Do you think the proposed requirements are too extensive and would result in more of a compliance exercise than in valuable communications on matters that affect your oversight responsibilities?
- ▶ Are there other matters beyond those cited in the proposal that should be communicated by the auditor only if management has not adequately done so?

Endnote:

- ¹ PCAOB, *Proposed Audit Standard Related to Communications with Audit Committees*, http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2011-008.pdf

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