Emerging issues that could affect Audits, Auditors or the PCAOB

November 2015

The views expressed by each of the presenters are their own personal views and not necessarily those of the PCAOB, members of the Board, or the PCAOB staff.

Panelists

Joan Amble
President, JCA Consulting, LLC
joanamble@jcaconsulting.org

Mike Gallagher
Managing Partner, Assurance Quality, PwC
michael.j.gallagher@pwc.com

Joyce Joseph
Principal, Capital Accounting Advisory and Research, LLC
jjoseph@capitaladvisorycpa.com

Sandy Peters
Head of Financial Reporting Policy, CFA Institute
sandra.peters@cfainstitute.org

Philip Santarelli
Partner, Baker Tilly Virchow Krause LLP
philip.santarelli@bakertilly.com

Emerging issues

<u>Emerging issues to be discussed by the panel</u>

- Whistleblower activity
- Economic developments
  - Falling oil prices
  - Low interest rates
- Use of data / data auditing
- Auditor’s role - non-GAAP measures
- Impact of FASB materiality proposals
- Revenue recognition transition

<u>Appendix – other emerging issues for consideration</u>

- Cybersecurity*
- Audit considerations resulting from mandatory audit firm rotation in the EU
- Auditing forward-looking assumptions
- Disruptive technology changes

*Subject of discussion at the June 24-25, 2014 SAG meeting

Whistleblower activity

- **Issue:**
  - The number of matters a Company investigates has increased, partially as a result of increased whistleblower and other “hotline” activity
  - Depending on the nature and significance of the allegation, a Company may need to engage outside counsel
  - The auditor has certain responsibilities under Section 10A
  - Often times these investigations are not fully resolved as of the 10Q/10K filing
- **Potential implications:**
  - Understanding of the role and responsibilities of the auditor and how they are impacted by the company’s process (e.g., independent vs. inside counsel, etc.)
  - Disclosures

Economic developments

- **Issue:**
  - ***Falling oil prices:*** Oil prices have declined in the past year. This decline may create business challenges and risks for a variety of companies, regardless of whether they are directly or indirectly part of the oil and gas industry supply chain
  - ***Low interest rates:*** Interest rates continue to remain at or near record lows. The Fed recently announced it would keep rates at or near record lows in the face of threats from a weak global economy, persistently low inflation and unstable financial markets
  - The auditor may need to consider the impact on its risk assessment
- **Potential implications:**
  - Impact to estimated future cash flows that could impact:
    - Valuation of goodwill or other long-lived assets (i.e., impairment)
    - Assessment of going concern
    - Recoverability of deferred tax assets
    - Collection of loans/receivables
    - Industry specific implications (e.g., impact to life insurance companies and the returns on its investments)
    - Pension plans / other post-employment benefits
    - Disclosures (risk factors, subsequent events, etc.)

Use of data / data auditing

- **Issue:**
  - Audit firms and preparers are making significant investments in technology, specifically regarding the use of data
  - These investments have the potential to enhance quality, provide additional insights and enhance the experience of staff
  - The audit firms may need to consider changes to its audit methodology and policies around how it handles client data
- **Potential implications:**
  - How do firm’s use technology to:
    - Enhance the audit process
    - Sustain and enhance the quality of audits
    - Leverage the investments made by companies
  - Ensure that auditing standards evolve as necessary to support expanded use of data auditing methods
  - Auditor’s consideration of a client’s use of technology
  - Impact on skillsets needed

Auditor’s role - non-GAAP measures

- **Background:**
  - As part of the Sarbanes-Oxley Act, the SEC adopted new disclosure regulations addressing non-GAAP public company disclosure: notably, Regulation G and amendments to Regulations S-K and S-B (“the regulations”)
- **Issue:**
  - The reporting, use of, and reliance on non-GAAP measures have increased; however, the auditor’s responsibilities have not changed
- **Potential implications:**
  - Elevate the level of independent audit assurance regarding compliance with the regulations and other related non-GAAP measurement rules under the SEC’s “Conditions for Use of Non-GAAP Financial Measures”
  - Enhance comparability, consistency, compliance, and accountability within financial reporting
  - Provide greater investor confidence
  - Increase the relevance of work performed by the auditor

Impact of FASB materiality proposals

- **Background:**
  - The FASB issued 2 exposure drafts in September 2015 aimed at clarifying the concept of materiality and aiding company management to exercise appropriate discretion in determining what is material and what need not be disclosed
- **Issue:**
  - Potentially reduces disclosures in the notes to the financial statements
  - Omissions of immaterial disclosures would not be an accounting error; therefore, omitted disclosures need not be communicated to audit committees
- **Potential implications:**
  - Impact on investor confidence in financial reporting
  - Re-visit related PCAOB auditing standards
  - Concerns over auditor interaction with audit committees
  - Assess auditor training/skills to address auditing management's determination of immateriality
  - Implementation challenges for preparers, including ICFR

Revenue recognition transition

- **Issue:**
  - Adoption of ASU 606 will be a significant accounting change for all issuers
  - Full retrospective adoption in 2018 will result in 2016 P&L being reported – issuers need to prepare accordingly
  - The ASU is still in flux with FASB still considering amendments
  - Many issuers are behind
- **Potential implications:**
  - ICFR concerns; retrospective measurement; ongoing auditing of new concepts (variable consideration, performance obligations, timing of recognition, capitalized costs, etc.)
  - Consideration of specific guidance for auditors

Appendix

Cybersecurity

- **Issue:**
  - Cybersecurity is an important business issue and, given the rise in high profile and high impact data breaches, it is receiving an increasing amount of attention by those in the business community
  - It is no longer viewed as just an "IT" issue. Rather, it is being treated as a broader business issue
  - The auditor currently has certain responsibilities with respect to ICFR, accounts and disclosures that may be impacted
- **Potential implications:**
  - Risk assessment
  - Scope of the audit
  - Aligning expectations of company/audit committees/investors
  - Accounting/audit responses in the event of a breach
  - Disclosures (risk factors, breach, etc.)

Audit considerations resulting from mandatory audit firm rotation in the EU

- **Issue:**
  - New rules in the EU requiring the mandatory rotation of audit firms will start impacting certain companies in 2020. Foreign private issuers in the EU will be impacted by these rules. In advance of that, many large issuers have already rotated auditors
  - Similar rules are being enacted or considered in various other jurisdictions
  - This is also expected to have an impact on certain US subsidiaries (and the related audits)
- **Potential implications:**
  - Impact on audit fees (potential for significant decline)
  - Potential distraction due to RFP's
  - Risk of first year audits
  - Different skills needed
  - Impact to firm/personal independence
  - US auditor of a component working with a group auditor of a non-network firm

Auditing forward-looking assumptions

- **Issue:**
  - Increased application of forward-looking assumptions in US GAAP (most notably the proposed expected credit loss model largely affecting the financial services sector, which was significantly affected during the 2008 financial crisis)
  - May result in a significant impact on the nature and reliability of audited quantitative measures and qualitative discussions in financial reporting
- **Potential implications:**
  - New /amended auditing guidance to address management use of forward-looking information and forecasts
  - Assess auditor skillsets/competencies that address the audit of management's use of forward-looking assumptions
  - Impact on auditor reliance on resources outside the audit firm
  - Impact on investor confidence, consistency, and comparability in financial reporting

Disruptive technology changes

- **Issue:**
  - Rapidly changing technology is disrupting business on a massive scale: big data, cloud computing, virtual supply chains, artificial intelligence, existential dependence on connectivity
- **Potential implications:**
  - Cybersecurity
  - How do companies maintain ICFR and how to auditors cope with the rapid changes
  - Increased operational risk; companies cannot keep up; investors are blind-sided
  - PCAOB Board consideration of establishing a standing task force to address the issues and consider the needs for standard setting, guidance, etc.

Breakout discussion