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PCAOB Rulemaking Docket Matter No. 030

I am pleased to have the opportunity to comment on PCAOB Release No. 2010-0001, "Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards" and on some of the suggestions offered in the September 21, 2010, Roundtable on the topic. To put my comments in perspective, I served as PCAOB Associate Chief Auditor and Director of Research from 2004 through 2006 and as a Consultant to the Office of Chief Auditor for one year prior to that and two years following that, which some may argue should preclude me from commenting. I have had no affiliation with the PCAOB since January 2009 and wish to offer some comments that represent my personal views and should not be attributed to the Board or the PCAOB staff.

I have followed this project from its inception and strongly believe the proposed standard represents a significant step in the right direction. I wish to offer a few suggestions for consideration.

1. ENHANCING COMMUNICATION RICHNESS AND AVOIDING CHECKLIST MENTALITY

All of the suggested communication items discussed in the proposed standard seem appropriate. However, the key to effective two-way communication is to utilize appropriate means for communicating and discussing these items

without creating information overload for the audit committee members or a “checklist mentality” for the auditor. An excellent suggestion made during the Roundtable was to concentrate on the richness of the communication (versus the leanness of communication associated with a checklist). (See the Roundtable comments of Dr. Lisa Gaynor, who was a member of the Research Synthesis Team on Auditor Communications with Audit Committees).

## 2. NEED TO ADDRESS BOTH AUDITORS AND AUDIT COMMITTEES

Effective two-way communication requires both effective auditors and effective audit committees. Although the PCAOB does not have authority over audit committees, it would seem appropriate to recognize (perhaps in the explanatory language of the release rather than in the body of the standard) that achieving the ultimate objective sought through auditor communications with audit committees requires that both parties need to be effective. The PCAOB has responsibility for addressing issues related to auditor effectiveness, but the issue of improving audit committee effectiveness also needs to be addressed. Although audit committee effectiveness has been improved in recent years, many audit committees lack the necessary levels of competence, independence, and power needed to function at the appropriate level.

## 3. SOME RESULTS OF RESEARCH MAY BE INTEGRATED INTO THE STANDARD OR SUGGESTIONS FOR BEST PRACTICES

The Auditing Section of the American Accounting Association established a team of researchers to prepare a synthesis of existing research that was relevant to auditor communications with audit committees. The results were shared with the staff of the PCAOB Office of Chief Auditor and published. A list of the key findings of this research synthesis is shown in the Appendix of this letter (under separate cover).

## 4. COMMENTS ON SPECIFIC ITEMS

- a. Paragraph 5. You may wish to consider including responsibilities of the audit committee as part of the suggested engagement letter. This is important because the audit committee may receive information (from management, internal audit, whistleblowers, or others) that is relevant to the auditor and should be communicated to and discussed with the auditor.
- b. Paragraph 12. The importance of two-way communication could perhaps be enhanced by changing “communicate to” (which entails

one-way communicate) to “communicate to and discuss with” (which entails two-way communication). The phrase “communicate to” suggests “leanness” of communication and may encourage a checklist mentality, while the phrase, “communicate to and discuss with” suggests a much richer form of two-way communication

## 5. COMMUNICATION REGARDING BROADER FINANCIAL REPORTING ISSUES

If audit committees are effectively performing their roles, they are responsible for financial reporting issues and areas that extend beyond the audited financial statements and reviewed quarterly information. It would seem helpful for the standard to address the desirability of two-way communication between the auditor and the audit committee regarding these broader financial reporting areas, without implying that these broader areas needed to be subject to audit attestation. (See Roundtable comments of J. Michael Cook).

I look forward to your moving forward with this proposed standard and hope these comments are helpful.

Sincerely,

Gary L. Holstrum, Ph.D., CPA, CFE, CFF  
(Former PCAOB Associate Chief Auditor and Director of Research)

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**APPENDIX TO HOLSTRUM COMMENT LETTER  
ON PCAOB Rulemaking Docket Matter No. 030**

**TABLE 1  
Implications of Research Findings for PCAOB Standard on Communications and  
Relations with the Audit Committee**

**Financial Reporting Quality**

- FRQ1: Given the significant impact of the audit committee and the board in reducing the likelihood of fraud and restatements, it is advisable that there be frequent communications between the auditor, the audit committee, and the board.
- FRQ2: Communications between the audit committee and the auditor should include discussions of areas susceptible to earnings management.
- FRQ3: The auditor and the audit committee should discuss factors that are not included in the financial statements that might drive managers to make aggressive accounting choices, such as analyst forecast data.

**Internal Controls**

- IC1: The nature and extent of communication between the auditor and the audit committee should vary based on whether the control weakness/deficiency relates to entity- or account-level controls.
- IC2: Firm-specific factors (e.g., financial distress, client size) should influence the communication about internal control issues between the auditor and the audit committee and/or require the auditor to communicate directly with the board on matters related to internal control.
- IC3: The audit committee and the auditor should pay attention to accruals quality when material internal control weaknesses or deficiencies are identified.
- IC4: Auditors' observations with respect to the effectiveness of the audit committee in discharging its responsibilities should be directly communicated to the board of directors.
- IC5: Given the important role played by the internal audit function in enhancing internal controls and quality financial reporting, there should be required communication between the audit committee and the external auditor on the quality of the internal audit function.
- IC6: The audit committee should take a proactive role in promoting an atmosphere to protect whistleblowers including discussing this process with the auditor.

**External Auditor Performance**

- EAP1: It is important for the auditor to communicate to the audit committee not only all relationships with the client and the nature of all services, but also if and how a proposed nonaudit service will be beneficial to the audit.
- EAP2: The auditor should report all consequential issues and proposed adjustments to the audit committee, regardless of whether they are resolved with the client.

- EAP3: The auditor should describe to the audit committee the process used for resolving contentious issues.
- EAP4: The auditor should report the nature of the partner-CFO relationship and explain the reason(s) for proposing a change of partner prior to the rotation period mandated by the Sarbanes-Oxley Act.
- EAP5: The auditor should not only communicate the proposed level of audit and nonaudit fees to the audit committee, but also indicate how the fees were determined, with explicit consideration of achieving quality services. One avenue for disclosing this information is in the engagement letter.
- EAP6: Mandating the requirement for an engagement letter conforms to current best practices. It might also be useful to consider explicitly outlining the responsibilities of the audit committee in the engagement letter along with those of management and the auditor.

**Other Issues**

- OI1: The audit committee and the auditor should pay more attention to the Management's Discussion and Analysis (MD&A), and they should evaluate each of the components of the MD&A as well as look at the convergence of the MD&A with external information.
- OI2: The complexity of information being conveyed, the potential issues of conflict, and the need for a formal record or precise language should determine whether communication should be written and/or oral. Using combinations of communication forms may be preferable in many circumstances.

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Source: Cohen, Jeffrey; Lisa Milici Gaynor; Ganesh Krishnamoorthy; and Arnold M. Wright. "Auditor Communications with the Audit Committee and the Board of Directors: Policy Recommendations and Opportunities for Future Research," *Accounting Horizons* (Vol. 21, No. 2, June 2007, pp. 165-187).