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PCAOB ROUNDTABLE

COMMUNICATIONS WITH AUDIT COMMITTEES

SEPTEMBER 21, 2010

A fundamental objective of the Sarbanes-Oxley Act of 2002 (the "Act") is to strengthen the role of the audit committee. To accomplish this objective, the Act requires that audit committee members of listed companies be independent and that such audit committees be responsible for the appointment, compensation, and oversight of the work of the external auditor (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing the auditor's report.[1/] These requirements, therefore, place the audit committee squarely at the center of the relationship between a public company and its auditor. The provisions of the Act that deal with the audit committee's oversight of the audit are predicated on the idea that independent, informed, and proactive audit committees can and should be key to protecting the interests of public company investors.

Building on this objective, on March 29, 2010, the Board proposed a new standard, *Communications with Audit Committees* ("proposed standard"), to enhance the relevance and effectiveness of the communications between the auditor and the audit committee.[2/] The proposed standard is intended to emphasize the importance of effective two-way communications between the auditor and the audit committee. The comment period for the proposed standard ended on May 28, 2010. The Board received thirty-five comment letters on the proposed standard.[3/] In addition, the PCAOB has scheduled a roundtable on

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[1/] See Sarbanes-Oxley Act of 2002, section 301; Securities Exchange Act of 1934, sections 10A(m)(2) and (3).

[2/] PCAOB Release No. 2010-001, *Proposed Auditing Standard Related to Communications with Audit Committees* (March 29, 2010).

[3/] Comments on the proposed standard are available on the Board's Web site at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

communications with audit committees on September 21, 2010. The objective of the roundtable is to obtain additional insight from investors, audit committee members, auditors, and management. The roundtable discussion also will explore some of the key issues commenters have raised and further develop ideas on how to improve communications between auditors and audit committees. The Board has reopened the comment period on the proposed standard until October 21, 2010 so that interested parties may provide comments on topics discussed during the roundtable.

This paper outlines the discussion topics for the roundtable and includes the questions that members of the roundtable will be asked to discuss.

Discussion Topic I: Communications Beneficial to Audit Committees

Audit committees have become an essential means through which boards of directors oversee the integrity of the company's financial reporting process, system of internal control, and the financial statements themselves. Among other things, the audit committee serves as the board of director's principal interface with the company's auditors and facilitates communications between the company's board of directors, its management and its independent auditors on significant accounting issues and policies. An audit committee that is well-informed about accounting and disclosure matters relating to the financial statements under audit might be better able to carry out its role of overseeing the audit and the financial reporting process.

The proposed standard would provide for additional communications from auditors beyond those required in AU sec. 380, *Communication With Audit Committees,* both on audit issues and on significant accounting matters. The proposed standard continues to allow auditors to communicate additional matters. Overall, commenters supported the enhancements to the communication requirements and noted that the proposed standard represents an improvement over the existing standard by incorporating the Securities and Exchange Commission's ("SEC") communication requirements and by incorporating requirements that are reflective of best practices. However, some commenters noted that some of the new communication requirements were either too broad or did not focus on providing information that is most relevant and meaningful to the audit committee in its oversight responsibilities.

Discussion Questions:

1. What matters related to the audit are most important to audit committee members in their oversight of the audit? Which of these

matters should be required to be communicated by the auditor to the audit committee?

2. What matters do investors believe audit committees need to know for effective oversight of the audit? Which of these matters should be required to be communicated by the auditor to the audit committee?

Discussion Topic II: Accounting Policies, Practices, and Estimates

The proposed standard retained many requirements in AU sec. 380 regarding communicating matters related to accounting policies, practices, and estimates. The proposed standard also incorporated the SEC requirements for the auditor to communicate directly to the audit committee critical accounting policies and alternative accounting treatments. (See Appendix A for an excerpt from the proposed standard regarding the proposed auditor communications related to accounting policies, practices, and estimates.) In addition, the proposed standard requires the auditor to communicate the following new matters to the audit committee if management has not adequately communicated such matters to the audit committee –

a. The anticipated application by management of accounting or regulatory pronouncements that have been issued but are not yet effective and may have a significant effect on financial reporting;

b. How management monitors critical accounting estimates subsequent to their development;

c. Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;

d. Any significant changes to assumptions or processes made by management to the critical accounting estimates in the year under audit, a description of the reasons for the changes, the effects on the financial statements, and the information that supports or challenges such changes; and

e. When critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and how various selections within the range would affect the company's financial statements.

The proposed standard also added a new requirement for the auditor to communicate to the audit committee any consultations by the auditor outside the engagement team related to significant accounting matters. This could include discussions with the firm's national office or industry specialists, or consultations with external parties when the firm does not have a national office.

There seemed to be consensus from commenters that the audit committee benefits from the auditor's insight regarding the strengths and weaknesses of the company's financial reporting. While investor commenters supported the new requirements in the proposed standard, some other commenters suggested the communication requirements were too prescriptive and might become a check-the-box exercise with a long list of required communications. Commenters emphasized that the requirements of the proposed standard should not overwhelm audit committee members with information that is not necessarily helpful; otherwise there is a risk that critical issues could be overlooked by the audit committee. Some commenters expressed concern that the expanded communication requirements might result in an increase in information provided to the audit committee at a level of detail that might detract from the effectiveness of the communications about critical accounting estimates and might result in a significant increase in auditor effort without a corresponding benefit to the audit committee.

Additionally, some commenters suggested that the requirement to communicate significant accounting matters for which the auditor has consulted outside the engagement team might act as a deterrent and therefore discourage necessary consultations. Several commenters suggested that the Board should specify which type or form of consultation should be communicated to the audit committee, such as formal consultation with the audit firm's national office, informal questions to other firm personnel, or outside experts. Some commenters also noted that significant accounting matters for which the auditor consulted outside the engagement team would be included in the significant accounting policies, practices, and estimates, that are required to be communicated to the audit committee in accordance with the proposed standard, therefore, an additional requirement to communicate these consultations is not necessary.

Discussion Questions:

3. How could the communication requirements be modified so that the auditor and the audit committee focus on the most significant accounting issues and estimates?

4. How could the proposed standard clarify the types of consultations that should be communicated to the audit committee?

5. Are there matters in addition to those in Appendix A that the proposed standard should require auditors to communicate, and if so what are those and why should they be required? Are there proposed requirements in Appendix A that should be omitted, and if so why?

Discussion Topic III: Effective Two-way Communication Between the Auditor and the Audit Committee

The proposed standard is intended to promote effective two-way communication between the auditor and the audit committee. Effective two-way communication is important in assisting –

- The auditor and the audit committee in understanding matters related to the audit and in developing a constructive working relationship;

- The auditor in obtaining from the audit committee information related to the audit; and

- The audit committee in the oversight of the audit, including resolution of disagreements between management and the auditor regarding financial reporting.

Several commenters noted that the audit committee might possess information that might not be readily available to the auditor from other sources and that effective two-way information of this nature, therefore, potentially might enhance the quality of the audit. Commenters suggested that two-way communication should not be limited to the auditor's inquiry of the audit committee about the risks of material misstatement, particularly if further information becomes available to the audit committee or the audit committee believes the auditor's assessments or conclusions might be incomplete or incorrect.

The proposed standard includes a requirement for the auditor to evaluate whether the two-way communications between the auditor and the audit committee have been adequate to support the objectives of the audit. This evaluation would be based on the auditor's interactions with the audit committee throughout the engagement. The proposed standard states that the auditor should base the evaluation on observations resulting from his or her interactions with the audit committee, which include, but are not limited to, the following –

- The appropriateness and timeliness of actions taken by the audit committee in response to matters raised by the auditor;

- The openness of the audit committee in its communications with the auditor;

- The willingness and capacity of the audit committee to meet with the auditor without management present; and

- The extent to which the audit committee probes issues raised by the auditor.

Many commenters acknowledged that inadequate two-way communication could have an effect on the auditor's assessment of the risks of material misstatement, which may effect the nature, timing, and extent of auditor procedures. However, several commenters suggested that an evaluation of the adequacy of the two-way communication can only be adequate if both parties are involved. If only the auditor evaluates the effectiveness based on his or her understanding of what was communicated, it doesn't provide information about the audit committee's understanding of that communication. Other commenters suggested expanding the requirement to require the auditor to evaluate the adequacy of the two-way communication between management and the audit committee.

Discussion Questions:

6. How important is effective two-way communication to the audit committee's responsibility to oversee the auditor? If it is important, how can the requirements in the proposed standard be modified to promote effective two-way communication? Additionally, considering that the PCAOB does not have oversight of audit committees, what other ways can the Board promote effective two-way communication without being able to impose any requirements on the audit committee?

7. How could the requirement for the auditor's evaluation of whether the communications with the audit committee have been adequate be modified to support the objectives of the audit?

8. Should the auditor's evaluation of effective two-way communications be expanded to include an evaluation of the communications between management and the audit committee?

Discussion Topic IV: Balance Between Written and Oral Communications

The proposed standard allows the auditor to communicate with the audit committee either in writing or orally, except for the engagement letter and the schedule of uncorrected misstatements, both of which are required to be in writing. The proposed standard requires the auditor to document the communications in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the proposed standard.

Commenters had mixed views on this requirement. Some commenters, particularly audit committee members, expressed the view that all required communications by the auditor to the audit committee should be in writing. Those commenters suggested that written communication allows audit committee members to focus on the most important matters and refer to the communication in subsequent periods, as necessary. Additionally, those commenters indicated that written communication would provide a record and avoid later disputes, confusion, and misunderstanding about what was communicated. Other commenters thought that flexibility should be permitted between written and oral communications since certain matters are best communicated in writing, while others might be better communicated through a robust dialogue with the audit committee. According to these commenters, requiring all communications to be made in writing could hinder the auditor's openness with the audit committee.

<u>Discussion Questions:</u>

9. Should all matters be communicated by the auditor to the audit committee in writing or only certain matters? If only certain matters should be communicated to the audit committee in writing, what are those matters? What are the risks of allowing some of the communications to be made orally?

10. If the standard were to require all required communications to the audit committee be in writing, should the auditor document oral discussions that relate to such written communications?

11. If all required communications to the audit committee were required to be in writing, would there be any effect on the dialogue between the auditor and the audit committee at audit committee meetings (i.e., would the dialogue on key matters continue to be robust)?

Discussion Topic V: Audit Committee Responsibilities in the Engagement Letter

The proposed standard states that the auditor should establish a mutual understanding of the terms of the audit engagement with the audit committee in connection with the audit. The mutual understanding includes communicating to the audit committee the following –

a. The objective of the audit;

b. The responsibilities of the auditor; and

c. The responsibilities of management.

The proposed standard also requires the auditor to record the understanding of the terms of the audit engagement in an engagement letter and to provide the engagement letter to the audit committee.

Several commenters stated that the mutual understanding should include the audit committee's responsibilities related to the audit of the company's financial statements and that those responsibilities also should be included in the engagement letter. One commenter suggested that the audit committee's responsibilities be described as follows –

- Providing oversight to the company's financial reporting.
- Informing the auditor of matters that might be related to the audit, including for example, knowledge of known or potential illegal acts and complaints or concerns regarding accounting or auditing matters.
- Communicating adequately and openly with the auditor, including, but not limited to the following –
    - Appropriate and timely actions taken in response to matters raised by the auditor;
    - A willingness to meet with the auditor without management present; and
    - Probing issues raised by the auditor.

Discussion Question:

12. Should the engagement letter include the responsibilities of the audit committee in addition to those of the auditor and management? If so, what should the responsibilities of the audit committee be?

Discussion Topic VI: Management Communications

The proposed standard acknowledges that management often discusses with the audit committee matters related to accounting policies, practices, and estimates. Like AU sec. 380, the proposed standard does not require that the auditor duplicate management's communications in these areas. The proposed standard, however, does require the auditor to communicate directly to the audit committee the auditor's views on the company's accounting policies, practices, and estimates or other communications as required by the SEC.[4/]

Several commenters suggested that auditors should not duplicate management's communications with the audit committee in other areas discussed in the proposed standard, such as going concern.

Discussion Question:

13. If management communicates relevant matters beyond those relating to accounting policies, practices, and estimates, should the auditor be allowed to omit those communications from the auditor's required communications?

Discussion Topic VII: Uncorrected Misstatements

The proposed standard requires the auditor to provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that was presented to management. While many commenters did not object to this requirement, several commenters suggested that the requirement would provide audit committees with too much detail.

Discussion Question:

14. Is it appropriate for the auditor to provide the audit committee with the same schedule of uncorrected misstatements that is presented

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[4/] See Rule 2-07 of Regulation S-X, 17 C.F.R. 210.2-07 and Rule 10A-3 under the Securities Exchange Act of 1934, 17 C.F.R. 240.10A-3.

to management? If not, what information related to uncorrected misstatements should the auditor provide to the audit committee?

Appendix A – Excerpt from Proposed Auditing Standard, *Communications with Audit Committees,* related to Accounting, Practices, and Estimates

Accounting Policies, Practices, and Estimates

12. The auditor should communicate the following matters to the audit committee regarding accounting policies, practices, and estimates:

a. Accounting policies and practices:

i. The initial selection of, and changes, in significant accounting policies or their application by management;

ii. The anticipated application by management of accounting or regulatory pronouncements that have been issued but are not yet effective and may have a significant effect on financial reporting;

iii. The methods used by management to account for significant and unusual transactions; and

iv. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

b. Critical accounting estimates:

i. A description of the process used by management to develop the critical accounting estimates and how such estimates are subsequently monitored by management;

ii. Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;

iii. Any significant changes to assumptions or processes made by management to the critical accounting estimates in the year under audit, a description of the reasons for the changes, the effects on the financial statements, and the information that supports or challenges such changes; and

iv. When critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and how various selections within the range would affect the company's financial statements.

Note: As part of its communications to the audit committee, management may communicate the above matters in paragraph 12 regarding accounting policies, practices, and estimates, in which case the auditor should determine whether all the matters were adequately described, and if not, the auditor should communicate any omitted or inadequately described matters to the audit committee.

Auditor's Evaluation of the Quality of the Company's Financial Reporting

13. The auditor should communicate to the audit committee the following matters:

a. Significant accounting policies and practices. The results of the auditor's evaluation of the quality, and not just the acceptability under the applicable financial reporting framework, of the company's significant accounting policies and practices, including a discussion of the:

   i. Quality, clarity, and completeness of the company's financial statements, which includes related disclosures; and

   ii. Consistency of the company's disclosures and of its selection and application of significant accounting policies and practices.

b. Critical accounting policies and practices. The discussion of critical accounting policies and practices should include:[5/]

   i. An evaluation of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that were not made by management;

   ii. The reasons certain policies and practices are considered critical by the auditor including those not considered critical by management; and

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[5/] See also Rule 2-07(a)(1) of Regulation S-X.

iii. How current and anticipated future events generally may affect the determination by the auditor of whether certain policies and practices are considered critical.

Note: Communication to the audit committee of critical accounting policies and practices is not considered a substitute for communications regarding the initial selection of, and changes in, significant accounting policies and practices. Management's selection of significant accounting policies and practices involves a broader range of transactions and events over time, while the description of critical accounting policies and practices should be tailored to specific events in the current year. Those accounting policies and practices considered to be critical might change from year to year.

c. Critical accounting estimates. Both the auditor's evaluation of the reasonableness of the process used by management to develop critical accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

d. Accounting Estimates. If the auditor determines that potential bias exists in management's accounting estimates.[6/]

e. Alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures, and the treatment preferred by the auditor.

f. Significant accounting matters for which the auditor has consulted outside the engagement team.

Note: This communication does not include discussions with the engagement quality reviewer in accordance with AS No. 7, *Engagement Quality Review.*

[6/] Paragraph 27 of the Auditing Standard No. 14, *Evaluating Audit Results* (adopted by the Board; pending SEC approval), includes requirements regarding the auditor's evaluation of bias in accounting estimates.