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PROPOSED AUDITING STANDARD RELATED TO COMMUNICATIONS WITH AUDIT COMMITTEES

AND RELATED AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS

PCAOB Release No. 2010-001
March 29, 2010

PCAOB Rulemaking
Docket Matter No. 030

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing an auditing standard, *Communications with Audit Committees,* which would supersede the Board's interim standards AU sec. 380, *Communication With Audit Committees,* and AU sec. 310, *Appointment of the Independent Auditor*, and would amend certain other PCAOB auditing standards. The text of the proposed standard and the related amendments (Appendices 1 and 2) will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 030 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 28, 2010.

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I. Introduction

For many companies and their auditors, the Sarbanes-Oxley Act of 2002 ("the Act") fundamentally changed the relationship between the audit committee[1/] and the auditor. The Act, along with the U.S. Securities and Exchange Commission's ("SEC") related implementation rules, strengthens and expands the role of the audit committee in overseeing a company's financial reporting process. The following sections of the Act amended the Securities Exchange Act of 1934 (the "Exchange Act"):[2/]

- Sections 201 and 202 of the Act - An issuer's audit committee shall pre-approve all audit and non-audit services to be provided by its auditor.
- Section 204 of the Act - Auditors shall communicate certain information to the audit committee.
- Section 301 of the Act - The SEC shall direct national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with certain requirements, including assigning the audit committee the responsibility to appoint, compensate, retain, and provide oversight of the auditor's work.

As the Act acknowledged, audit committees play an important role in protecting the interests of investors. The audit committee assists the board of directors in fulfilling its responsibility to company shareholders and others to oversee the integrity of a company's financial statements and the financial reporting process. An audit committee that is well-informed about accounting and disclosure matters relating to the audit may be better able to carry out its role of overseeing the financial reporting process. One way the audit committee may be informed of accounting and disclosure matters is through the communication of the auditor's evaluations of matters that are significant to the financial statements. Effective two-way communications between the auditor and

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1/ The term audit committee, as used in this release, refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the term refers to the entire board of directors of the company.

2/ The Act amended Section 10A(h), (i), (k) and (m) of the Exchange Act.

the audit committee on such matters might also benefit the auditor in performing the audit.[3/]

The Board is proposing a new auditing standard (the "proposed standard") that would replace interim standards AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), and AU sec. 310, *Appointment of the Independent Auditor* ("AU sec. 310"), which were written prior to the Act when management of a listed company, rather than the audit committee, was often responsible for engaging and overseeing the auditor. The Board's primary objectives in proposing a new standard are to: (1) enhance the relevance and effectiveness of the communications between the auditor and the audit committee; and (2) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit.

The proposed standard has been influenced by a number of factors and developments, including the increasing use of risk-based audit methodologies and the emphasis on judgments and estimates in the financial reporting frameworks. Additionally, the Board's Standing Advisory Group ("SAG") has discussed auditor communications with audit committees on several occasions. SAG members have expressed support for the Board proposing a new standard that enhances the auditor communications with the audit committee, especially in the areas of disclosures and critical accounting estimates.[4/]

To address these factors, the Board considered the following items in drafting the proposed standard:

- Integrating the Requirements for the Auditor's Appointment and Auditor Communications with the Audit Committee – Given the responsibility of many audit committees for the appointment and retention of the auditor, the proposed standard combines the requirements from the Board's interim auditing standards AU sec. 310 and AU sec. 380 into one auditing standard. The Board considered whether required communications in the

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[3/] An audit is either a financial statement audit or an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

[4/] Webcasts of these meetings are available on the Board's website at: www.pcaobus.org/News_and_Events/Webcasts.

Board's other standards and rules, such as AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services,* should be amended and also included in the proposed standard. The proposed standard does not combine communication requirements in the Board's other standards and rules. Rather than moving all auditor communication requirements into one standard, the proposed standard includes an appendix that identifies other PCAOB standards and rules that require communication with the audit committee about specific matters. The proposed standard is intended to set forth requirements regarding the auditor's overall communication responsibilities with the audit committee that are applicable to all audits conducted in accordance with PCAOB standards.

- Overview of the Audit Strategy, Including the Auditor's and Audit Committee's Consideration of Significant Risks – In performing a risk-based audit, the auditor's assessment of significant risks[5/] is an important consideration regarding the tests of controls and substantive procedures performed. Communication of the significant risks identified by the auditor gives the audit committee an opportunity to understand the auditor's view of the most important risks of material misstatements and to communicate its views relating to those risks based on its knowledge of the company. The auditor's understanding of the audit committee's view of the company's risks could assist in the development of the auditor's risk assessment and audit strategy, ultimately resulting in an improvement to audit quality.

- Accounting Policies and Estimates – In developing the proposed standard, the Board considered the importance of not just the accounting policies, practices, and estimates used to prepare the financial statements, but also management's judgments and assumptions underlying the financial results. Knowledge of the potential variability that exists relating to assumptions made in developing the estimates also plays a key role in understanding the risks of material misstatement. The proposed standard includes a number of requirements relating to the communication of these matters to the audit committee, including the auditor's evaluation of the quality of the company's accounting policies, practices, and estimates.

[5/] Paragraph A5 of the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* defines significant risk.

- Timing of Communications – Timely communications from the auditor provide the audit committee with the opportunity to make informed decisions and to take actions that may affect the quality of both the audit and the financial statements. The significance of the matter to be discussed and any corrective or follow-up action needed on the part of the audit committee are considered in determining the timing of communications required by the proposed standard. Additionally, the proposed standard requires communications be made no later than the issuance of the auditor's report.[6/]

The proposed standard carries forward substantially all of the required communications in AU sec. 380. For certain matters, the proposed standard requires communication of additional matters. For example, to provide the auditor with a central location for required communications with audit committees regarding accounting matters, the proposed standard includes requirements that are consistent with the SEC's audit committee communication requirements. Additionally, in drafting the proposed standard, the Board considered the requirements of the relevant standards of the International Auditing and Assurance Standards Board ("IAASB") and the American Institute of Certified Public Accountant's Auditing Standards Board ("ASB").

Appendix 1 to this release contains the text of the proposed standard, *Communications with Audit Committees*. The proposed standard has three appendices: (1) Appendix A - Definitions, (2) Appendix B - Communications with Audit Committees Required by Other PCAOB Standards and Rules, and (3) Appendix C - Matters Communicated in the Audit Engagement Letter. Appendix 2 to this release contains proposed amendments to other existing standards to conform them to the requirements and direction in the proposed standard. Appendix 3 provides a comparison of the proposed standard to the relevant standards of the IAASB and the ASB.

II. Overview of the Proposed Standard

The Board's proposed standard is intended to strengthen the existing requirements for auditor communications with the audit committee. The Board requests comments on all aspects of the proposed standard and is particularly interested in responses to the specific questions below.

[6/] Consistent with Rule 2-07 of Regulation S-X, in the case of a registered investment company, if the annual communication is not within 90-days prior to the filing, the auditor should provide an update, in the 90-day period prior to the filing, of any changes to the previously reported information.

A. Objectives of the Auditor

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed standard. The objectives of the auditor are (a) communicating to the audit committee the responsibilities of the auditor in relation to the audit and establishing a mutual understanding of the terms of the audit engagement with the audit committee; (b) communicating to the audit committee an overview of the audit strategy and timing of the audit; (c) providing the audit committee with timely observations arising from the audit that are significant and relevant to the financial reporting process; and (d) evaluating the adequacy of the two-way communications between the auditor and the audit committee to support the objectives of the audit.

Question:

1. Are the objectives of the auditor in the proposed standard appropriate? If not, why? Should other matters be included in the objectives?

2. Are the objectives adequately articulated? Should the articulation of the objectives focus on the outcome that should be achieved by performing the required procedures?

B. Establish a Mutual Understanding of the Terms of the Audit

In considering the audit committee's responsibility to oversee the appointment, compensation, and retention of the auditor, the Board has included in the proposed standard a requirement for the auditor to establish a mutual understanding of the terms of the audit engagement with the audit committee. Unlike AU sec. 310, which requires an understanding to be established with the client of the services to be performed, the proposed standard requires that this understanding be established specifically with the audit committee. Unlike AU sec. 310, the proposed standard requires the auditor to record this understanding in a written audit engagement letter, and to include the understanding of the objective of an audit and the responsibilities of the auditor and management. The proposed standard also requires the auditor to provide the engagement letter to the audit committee and, like other communication requirements, the engagement letter is required to be provided annually. Appendix C of the proposed standard describes matters that should be included in an engagement letter. That appendix incorporates the direction in AU sec. 310 relating to the objective of the audit and the responsibilities of the auditor and management and amends that direction to reflect the auditor's current responsibilities under PCAOB standards and rules.

Questions:

3. Is it appropriate for the proposed standard to require that an engagement letter be prepared annually? If not, why?

4. Are there other matters that would enhance investor protection that should be added to an engagement letter? If so, what other matters should be included in an engagement letter?

C. Obtaining Information Related to the Audit

The Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* includes a requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks.[7/] The proposed standard includes a requirement to inquire of the audit committee about whether they are aware of other matters that may be relevant to the audit, including complaints or concerns raised regarding accounting or auditing matters. Audit committees of listed issuers are required to establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters.[8/] Complaints or concerns may come to the audit committee's attention through the company's process for reporting concerns related to financial reporting[9/] that are relevant to the audit. Inquiring of the audit committee regarding issues relevant to the audit might encourage an open two-way communication between the auditor and the audit committee.

It is important that the discussions of these matters with the audit committee be robust and substantive. For example, an open discussion may encourage more dialogue between the auditor and the audit committee regarding the risks of material misstatement and other matters relevant to the audit.

7/ Paragraph 51 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement* and paragraph 22 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

8/ See Exchange Act Section 10A(m)(4) and Rule 10A-3(b)(4).

9/ See Exchange Act Rule10A-3(b)(3).

Question:

5. Is the proposed requirement to inquire of the audit committee appropriate? What other specific inquiries, if any, should the proposed standard include for the auditor to make of the audit committee?

D. Overview of the Audit Strategy and Timing of the Audit

The proposed standard has a new requirement for the auditor to communicate to the audit committee an overview of the audit strategy, including a discussion of the significant risks identified by the auditor, and the timing of the audit. Early communication of these matters may enable the audit committee to understand the auditor's views regarding risk and to provide insights regarding additional risks not identified by the auditor in order for the auditor to incorporate them into the audit strategy.

The proposed standard also includes a requirement for the auditor to communicate, in a timely manner, significant changes to the planned audit strategy or the significant risks initially identified that may occur during the audit due to the results of audit procedures or in response to external factors, such as changes in the economic environment.

Additional matters that the auditor should communicate as part of the audit strategy, if relevant, include:

- The auditor's determination of whether persons with specialized skill or knowledge are needed to apply the planned audit procedures or evaluate the audit results;[10/]

- The auditor's consideration of and planned use of the company's internal audit function to perform audit procedures in the audit of financial statements;

- The auditor's consideration of the extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or

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[10/] Paragraph 16 of Proposed Auditing Standard, *Audit Planning and Supervision,* requires the auditor to determine whether specialized skill or knowledge is needed to perform audit procedures.

the audit committee when conducting an audit of internal control over financial reporting;

- The roles, responsibilities, and locations of firms participating in the audit; and

- The basis for the auditor's determination that he or she can serve as principal auditor.

The proposed standard includes these communication requirements to address instances in which the auditor uses the assistance of other firms to perform audit procedures. Auditors may use affiliated or network firms, outsourcing arrangements, or non-affiliated firms to perform audit procedures. Communication of these arrangements to the audit committee provides information regarding the parties involved in the audit who will perform audit procedures that the auditor will evaluate as part of the consideration of whether sufficient appropriate audit evidence has been obtained and also facilitates an effective discussion of how the work of other parties affects the audit.

The proposed standard notes that care is required when the auditor communicates the audit strategy and timing of the audit so as not to compromise the effectiveness of the audit procedures. For example, communicating details about specific audit procedures might reduce the effectiveness of those procedures.

Questions:

6. Are the requirements to provide information on the auditor's audit strategy and timing of the audit appropriate? Does the auditor need more guidance related to the requirement to provide information on the auditor's audit strategy? If so, what type of guidance would be helpful?

7. Is it sufficiently clear which types of arrangements should be communicated to the audit committee related to the roles, responsibilities, and locations of firms participating in the audit?

E. Accounting Policies, Practices, and Estimates

The proposed standard retains the requirements in AU sec. 380 on communication requirements relating to accounting policies, practices, and estimates. Similar to AU sec. 380, the proposed standard also acknowledges that management may be communicating certain matters related to the financial reporting process to the audit committee. In such cases, AU sec. 380 requires that the auditor determine whether the audit committee was informed about certain matters related to accounting policies, practices, and estimates required by that standard. Similarly, the proposed standard requires the auditor to communicate matters related to accounting polices, practices, and estimates. However, if management has already communicated the matters in paragraph 12 of the proposed standard, the auditor should determine whether the matters were adequately described by management, and if not, the auditor should communicate any omitted or inadequately described matters required by the proposed standard to the audit committee. A related proposed amendment to paragraph .34 of AU sec. 722*, Interim Financial Information,* is included in Appendix 2.

Accounting Policies and Practices

AU sec. 380 requires the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles. AU sec. 380 requires this discussion generally to include such matters as the consistency of the company's accounting polices and their application and the clarity and completeness of the company's financial statements, which include related disclosures. Similarly, the proposed standard requires the auditor to communicate the auditor's evaluation of the quality, not just the acceptability, of the company's significant accounting policies and practices and the quality of disclosures related to the company's accounting policies and practices. In evaluating the quality of disclosures, the auditor understands, however, that an accurate application of authoritative accounting pronouncements in the financial statements often either requires, or would be more informative if accompanied by, appropriate and clear disclosures that facilitate an investor's understanding of the company's accounting and financial condition. In making his or her evaluation of the overall quality of the disclosures, therefore, the auditor considers whether all appropriate disclosures are made and whether the disclosures facilitate an investor's understanding of the financial statements and related financial information.

Companies should include disclosure regarding the potential effects of adoption of accounting standards that have been issued but not yet adopted in registration statements and reports filed with the SEC.[11/] The proposed standard includes a new requirement for the auditor to communicate, or determine that management has adequately communicated to the audit committee, the anticipated application of new accounting or regulatory pronouncements that are not yet effective, but which may, upon adoption, have a significant effect on the company's financial reporting. The auditor may develop a view regarding changes to processes or systems that could impact the financial reporting process that would not be included in management's

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[11/] See Codification of Staff Accounting Bulletins, Topic 11.M., Question 1.

disclosures in the financial statements, but which the auditor may wish to communicate to the audit committee. A discussion of such matters in more detail with the audit committee may allow audit committees time to properly consider the effects on future financial statements as well as ramifications on the financial reporting process.

The proposed standard includes requirements that are consistent with those in Rule 2-07 of Regulation S-X[12/] for the auditor to communicate critical accounting policies and practices directly to the audit committee as well as alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items discussed with management. Communication to the audit committee of critical accounting policies and practices is not considered a substitute for communications regarding the initial adoption 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 is tailored to specific events in the current year. These requirements may help the auditor in making all the required accounting-related communications to the audit committee, including those of the SEC. With respect to the communication of critical accounting policies, the proposed standard requires the auditor to communicate, among other things, how current and anticipated future events may affect the determination by the auditor of whether certain policies and practices are considered critical. For example, a significant merger or acquisition may result in the related accounting policy being considered critical in the year in which the transaction occurs, but not in subsequent years.

The proposed standard also includes another new requirement for the auditor to communicate to the audit committee significant accounting matters on which the auditor has consulted outside the engagement team. 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. These consultations do not include discussions with the engagement quality reviewer. This information will benefit the financial reporting process by providing the audit committee with information about complex transactions that may be high risk or controversial.

Accounting Estimates

Accounting estimates including fair value measurements are an integral part of the financial statements prepared by management and are based upon management's

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[12/] 17 CFR 210.2-07.

current judgments. Those judgments normally are based on knowledge and experience about past and current events and assumptions about future events.

The proposed standard defines the term "critical accounting estimate" as an accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and (b) the impact of the estimate on financial condition or operating performance is material. This is the same definition used by the SEC.[13/] The proposed standard uses the term critical accounting estimate to help focus the communication to the audit committee on those estimates including fair value measurements that are subject to a higher risks of material misstatement. The definition of a critical accounting estimate is intended to include those that are "particularly sensitive" as used in AU sec. 380.

Further, the proposed standard includes new requirements for the auditor to communicate, or to evaluate whether management has adequately communicated, the following matters:

a. How management subsequently monitors critical accounting estimates;

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

c. A discussion of 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

d. 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 requires the auditor to communicate his or her evaluation regarding 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. In addition, the proposed standard requires the

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[13/] *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations,* Release No. 33-8350 (December 19, 2003).

auditor to communicate to the audit committee situations where the auditor determines that potential bias exists in management's accounting estimates.[14/] This requirement is similar to the requirement in paragraph .09 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312.*

Questions:

8. Are the proposed requirements regarding the auditor's communication responsibilities with respect to accounting policies and practices sufficiently clear in the proposed standard (e.g., is the difference between a critical accounting policy and a significant accounting policy or practice adequately described)?

9. Is it helpful to include in the proposed standard the audit committee communications required by the SEC relating to accounting matters?

10. Is the definition of critical accounting estimates appropriate for determining which estimates should be communicated to the audit committee?

11. Are the communication requirements regarding critical accounting estimates appropriate? If not, how should the proposed standard be modified to provide appropriate information to the audit committee?

F. Management Consultations with Other Accountants

The proposed standard carries forward the requirement from AU sec. 380 for the auditor to communicate to the audit committee when the auditor is aware that management consulted with other accountants about auditing or accounting matters (e.g., if management consults with other accountants about the appropriate accounting for a transaction). In those situations, the auditor should communicate to the audit committee his or her views about significant matters that were the subject of such consultation.

[14/] Paragraph 27 of the Proposed Auditing Standard, *Evaluating Audit Risks,* includes requirements regarding the auditor's evaluation of bias in accounting estimates.

Question:

12. Should this requirement be expanded to include consultations on accounting or auditing matters with non-accountants, such as consulting firms or law firms?

G. Going Concern

As part of the audit, the auditor has a responsibility to evaluate whether there is substantial doubt about the company's ability to continue as a going concern[15/] for a reasonable period of time.[16/] The auditor's evaluation is based on, among other things, his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

The proposed standard requires the auditor to communicate to the audit committee certain matters, when applicable, relating to his or her evaluation of a company's ability to continue as a going concern. The matters to be communicated depend on the auditor's conclusion. If the auditor concludes that there could be substantial doubt but the auditor's doubt is mitigated, the proposed standard requires the auditor to communicate the conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt about the company's ability to continue as a going concern as well as the information that mitigates the auditor's doubt. If the auditor's doubt is not mitigated and the auditor concludes that there is substantial doubt about the company's ability to continue as a going concern, the proposed standard requires certain additional matters be communicated.

Question:

13. Is the communication requirement on going concern clear? If not, how could the requirement be clarified?

15/ The requirements included in this standard may change depending on the outcome of the Financial Accounting Standards Board's project regarding going concern.

16/ AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

H. Corrected and Uncorrected Misstatements

The proposed standard requires the auditor to provide the audit committee with the schedule of uncorrected misstatements relating to accounts and disclosures that was presented to management. Presenting only a schedule that, for example, shows only the net effect of the uncorrected misstatements rather than the individual misstatements may be misleading. The proposed standard also requires the auditor to communicate the basis for the auditor's determination that the uncorrected misstatements were immaterial, including the qualitative factors[17/] considered as well as communicate those corrected misstatements that might not have been detected except through the auditing procedures performed, including the implications such corrected misstatements might have on the financial reporting process.

Questions:

14. Are the requirements appropriate regarding the communications for uncorrected misstatements?

15. Should all corrected misstatements including those detected by management be communicated to the audit committee?

I. Other Matters

The proposed standard includes a new requirement for the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process, including situations where the auditor is aware of complaints or concerns raised regarding accounting or auditing matters, not including matters previously reported to the auditor by the audit committee. This requirement acknowledges that there are other matters that may be beneficial to the financial reporting process when communicated to the audit committee.

J. Form and Content of Communications

Similar to AU sec. 380, the proposed standard provides for written or oral communication of the matters the standard requires, unless otherwise specified in the proposed standard. Effective communication may take many forms, such as presentations, written reports, or robust discussions. Having written communications

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[17/] Paragraphs .15-.17 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312,* include qualitative factors to consider the qualitative characteristics of misstatements.

may provide the auditor with a basis to lead an active two-way discussion with the audit committee. When considering how to communicate highly complex information (e.g., information about critical accounting estimates), written information often makes it easier for others to understand the information; however, having a robust dialogue on key matters is the most important factor in effective communications with the audit committee.

The auditor is required to document the communications, whether communicated orally or in writing, in sufficient detail to enable an experienced auditor,[18/] having no previous connection with the engagement, to understand the communications made to comply with the provisions of this proposed standard. An amendment to paragraph .30 of AU sec. 722, *Interim Financial Information,* to include a similar requirement regarding documentation of communications with audit committees is included in Appendix 2. These documentation requirements follow the direction in PCAOB Auditing Standard No. 3, *Audit Documentation.* Regardless of the method of communication, the auditor is encouraged to have open and substantive dialogue with the audit committee.

Question:

16. Like the existing standard, the proposed standard would allow the auditor to communicate many matters orally or in writing. Should the standard require that all or certain matters be communicated to the audit committee in writing? If only certain matters should be communicated to the audit committee in writing, what are those matters?

K. Timing

The Board considers communications with audit committees to be an integral part of the audit process. Therefore, unlike AU sec. 380, which states that audit committee communications are incidental to the audit and are not required to occur before the issuance of the auditor's report, the proposed standard requires timely communication by the auditor to the audit committee of the matters required by the proposed standard, and that all matters required by the proposed standard be communicated prior to the issuance of the auditor's report. AU sec. 380 also does not require the auditor to repeat the communication of recurring matters each year. The proposed standard requires that matters be communicated annually, as significant

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[18/] As described in paragraph 6 of AS No. 3, *Audit Documentation,* "[a]n experienced auditor has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

matters may change based on changes in the economy, the volume of transactions, or the significance to the audit or the financial statements. Although the communications are required to be made annually, the time spent on the discussion of matters presented could vary from year to year based on changes in circumstances or other factors, such as a change in the members of the audit committee.

An amendment to paragraph .36 of AU sec. 722, *Interim Financial Information,* to require that the auditor complete any necessary communications with the audit committee prior to the company's filing of its interim financial information with a regulatory agency, such as the SEC is included in Appendix 2.

The appropriate timing for communications may vary with the circumstances of the engagement. For example, some communications, such as information regarding the audit strategy and the significant risks, should be made as early as possible and other matters, such as changes to the auditor's significant risks initially identified should be communicated in a timely manner. The auditor should communicate certain matters earlier than other matters, and more frequently, depending on the relative significance of the matters noted, the corrective follow-up actions by the audit committee, and other factors. For instance, the auditor should communicate significant difficulties with management or other matters that are adversely affecting the progress of the audit as soon as practicable to allow the audit committee to take appropriate action to enable the audit to be completed.

Question:

17. Are the requirements in the proposed standard on the timing of the auditor's communications appropriate? Should only certain matters be communicated annually? If so, which ones?

L. Adequacy of the Two-way Communication Process

Certain SAG members have emphasized that effective two-way communications between the auditor and the audit committee will benefit the audit process. The proposed standard includes a new requirement for the auditor to evaluate whether the two-way communications between the auditor and the audit committee have been adequate to support the objective of the audit. If not, the proposed standard requires the auditor to evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence. This requirement is included to emphasize that effective two-way communications are beneficial to achieving the objective of the audit. The auditor should base the evaluation on observations resulting from his or her interactions with the audit committee throughout the audit process.

Question:

18. Does the requirement to evaluate the adequacy of the communication process promote effective two-way communications? Is more information on this requirement needed?

M. Other Communication Requirements

Significant Issues Discussed with Management Prior to the Appointment or Retention

The proposed standard retains the requirement in AU sec. 380 for the auditor to discuss with the audit committee any major issues that were discussed with management in connection with the initial appointment or retention of the auditor. This requirement was originally written when auditors often were hired directly by management. As previously stated, Section 301 of the Act and SEC rules require that audit committees of companies with securities listed on a national exchange or with a national securities association be directly responsible for the appointment, compensation, and oversight of the work of the auditors. However, even when ultimate authority rests with the audit committee, the audit committee may ask management for its views of the auditor's performance based on the significant amount of interaction between the auditor and management.

To ensure that the audit committee is aware of all discussions that may influence management's views about the auditor or about significant accounting or auditing issues, the proposed standard retains the requirement from AU sec. 380 for the auditor to communicate significant issues discussed with management prior to his or her appointment or retention. In determining what information to communicate to the audit committee, "retention" is not meant to limit this communication to discussions that occur shortly before re-appointment, but could include discussions occurring throughout the auditor's relationship with the company.

Other Information in Documents Containing Audited Financial Statements

The proposed standard retains the requirement for the auditor to communicate to the audit committee the auditor's responsibility for other information presented in documents containing audited financial statements, any related procedures performed, and the results of such procedures.[19/]

Departure from the Standard Auditor's Report

The proposed standard includes a new requirement for the auditor to communicate to the audit committee when the auditor expects to modify the opinion in the auditor's report or include an explanatory paragraph,[20/] the reasons for the modification or explanatory paragraph, and the proposed wording of the modification or explanatory paragraph.

Disagreements with Management

The proposed standard includes the requirement from AU sec. 380 for the auditor to 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 financial statements or the auditor's report. Examples include disagreements with management about the application of accounting principles to the company's specific transactions and events, and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be made in the company's financial statements, or the wording of the auditor's report. This communication requirement does not include differences of opinion based on incomplete facts or preliminary information that are later resolved prior to the issuance of the auditor's report.

Difficulties Encountered in Performing the Audit

The proposed standard includes the requirement from AU sec. 380 for the auditor to inform the audit committee of any significant difficulties encountered in dealing with management related to the performance of the audit. Significant difficulties encountered during the audit include:

[19/] Paragraphs .04-.07 of AU section 550, *Other Information in Documents Containing Audited Financial Statements,* require that the auditor read the information and consider whether it is materially inconsistent with information in the financial statements or whether it contains any material misstatements.

[20/] Paragraphs .11-.76 of AU sec. 508, *Reports on Audited Financial Statements*.

- Significant delays by management or an unwillingness by management to provide information needed for the auditor to perform his or her procedures;

- An unnecessarily brief time within which to complete the audit;

- Extensive, unexpected effort required to obtain sufficient appropriate audit evidence;

- Unreasonable restrictions imposed on the auditor by management; and

- Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested.

Questions:

19. Are these other communication requirements appropriate and sufficiently clear? What other communication requirements should the proposed standard include, if any?

20. Are the matters included as significant difficulties in paragraph 21 of the proposed standard appropriate? What other matters should be included as significant difficulties?

21. Are any of the requirements included in the proposed standard inappropriate for auditors to communicate to audit committees based on the size or industry of the company under audit?

N. Appendices

The proposed standard includes the following three appendices:

- Appendix A – Definitions

- Appendix B - Communications with Audit Committees Required by Other PCAOB Standards and Rules

- Appendix C - Matters Communicated in the Audit Engagement Letter

Question:

22. Is the information included in Appendices A - C to the proposed standard sufficiently clear? Should the appendices include other matters, e.g., should other items be included in an audit engagement letter?

O. Effective Date

The Board anticipates that the standard would be effective, subject to approval by the SEC, for audits of fiscal years beginning after December 15, 2010.

III. Opportunity for Public Comment

The Board will seek comment on the proposed standard and related amendments for a 60-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 030 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 28, 2010.

The Board will consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

On the 29th day of March, in the year 2010, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

Proposed Auditing Standard

Communications with Audit Committees

Supersedes AU sec. 380: Communication With Audit Committees, and AU sec. 310: Appointment of the Independent Auditor

Introduction

1. This standard establishes requirements for the auditor regarding certain matters related to the conduct of an audit[1/] that are communicated to a company's **audit committee**[2/] in connection with an audit. The communications between the auditor and the audit committee include establishing a mutual understanding of the terms of the audit engagement. The standard also requires the auditor to document that understanding in an engagement letter. Effective two-way communications throughout the audit assist the auditor and the audit committee in understanding matters related to the audit. The standard requires the auditor to evaluate the adequacy of the two-way communications between the auditor and the audit committee.

2. Other Public Company Accounting Oversight Board ("PCAOB") rules and standards identify additional matters to be communicated to a company's audit committee, which complement the requirements of this standard (see Appendix B). Various laws or regulations also require other matters to be communicated.[3/] The requirements of this standard do not modify communications required by those other laws or regulations. Nothing in this standard precludes the auditor from communicating other matters to the audit committee.

[1/] For purposes of this standard, an audit is either a financial statement audit or an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

[2/] Terms defined in Appendix A, *Definitions,* are set in **boldface type** the first time they appear.

[3/] See, e.g., Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; Item 407 of Regulation S-K, 17 CFR 229.407; and Rule 10A-3 under the Securities Exchange Act of 1934, 17 CFR 240.10A-3.

Objectives

3. The objectives of the auditor are:

   a. Communicating to the audit committee the responsibilities of the auditor in relation to the audit and establishing a mutual understanding of the terms of the audit engagement with the audit committee;

   b. Communicating to the audit committee an overview of the audit strategy and timing of the audit;

   c. Providing the audit committee with timely observations arising from the audit that are significant and relevant to the financial reporting process; and

   d. Evaluating the adequacy of the two-way communications between the auditor and the audit committee to support the objectives of the audit.

Matters to be Communicated

Significant Issues Discussed with Management Prior to the Auditor's Appointment or Retention

4. The auditor should discuss with the audit committee any significant issues discussed with management in connection with the appointment or retention of the auditor, including any discussions regarding the application of accounting principles and auditing standards.

Establish a Mutual Understanding of the Terms of the Audit

5. The auditor should establish a mutual understanding of the terms of the audit engagement with the audit committee in connection with the audit.[4/] This mutual understanding includes communicating to the audit committee the following:

[4/] Audit committees of public companies with securities listed on a national exchange or with a national securities association have specific responsibilities regarding the appointment, retention, compensation, and oversight of the auditor. See Rule 10A-3(b)(2) under the Securities Exchange Act of 1934, 17 CFR 240.10A-3(b)(2).

a. The objective of the audit;

b. The responsibilities of the auditor; and

c. The responsibilities of management.

6. The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee. The auditor should have the engagement letter executed by the appropriate party or parties.

Note: Appendix C describes in more detail, matters that should be included in the engagement letter about the terms of the audit engagement.

7. If the auditor cannot establish a mutual understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept or perform the engagement.

Overview of the Audit Strategy and Timing of the Audit

Obtaining Information Related to the Audit

8. The auditor should inquire of the audit committee whether it is aware of matters that may be related to the audit, including complaints or concerns raised regarding accounting or auditing matters.[5/]

[5/] Paragraph 53.b.(3) of the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to inquire of the audit committee, or its chair, whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program) and, if so, the audit committee's responses to such tips and complaints.

Audit Strategy and Timing of the Audit

9. The auditor should communicate to the audit committee an overview of the audit strategy,[6/] including a discussion of the significant risks[7/] identified during his or her risk assessment procedures, and the timing of the audit.

> Note: The overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures. Communicating specific details regarding audit procedures might reduce the effectiveness of those procedures.

10. The auditor also should communicate the following matters to the audit committee, if applicable:

a. The auditor's determination of whether persons with specialized skill or knowledge are needed to apply the planned audit procedures or evaluate the audit results;[8/]

b. The auditor's consideration of, and planned use of, the company's internal audit function to perform audit procedures in an audit of financial statements;[9/]

c. The auditor's consideration of the extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal

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[6/] Paragraph 8 of the Proposed Auditing Standard, *Audit Planning and Supervision,* describes the auditor's responsibilities for establishing an audit strategy.

[7/] Paragraph A5 of the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* defines significant risk.

[8/] Paragraph 16 of Proposed Auditing Standard, *Audit Planning and Supervision,* requires the auditor to determine whether specialized skill or knowledge is needed to perform audit procedures.

[9/] AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* describe the auditor's responsibility for considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor in an audit.

auditors), and third parties working under the direction of management or the audit committee when conducting an audit of internal control over financial reporting;[10/]

d. The roles, responsibilities, and locations of firms participating in the audit; and

e. The basis for the auditor's determination that he or she can serve as principal auditor.[11/]

11. The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified.

Issues Arising from the Audit

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

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[10/] Paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* describes the auditor's responsibility related to using the work of others in an audit of internal control over financial reporting.

[11/] AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* discusses the professional judgments the auditor makes in deciding whether he or she may serve as principal auditor.

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:[12/]

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

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.[13/]

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

[13/] Paragraph 27 of the Proposed Auditing Standard, *Evaluating Audit Risks,* includes requirements regarding the auditor's evaluation of bias in accounting estimates.

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.*

Other Information in Documents Containing Audited Financial Statements

14. When other information is presented in documents containing audited financial statements,[14/] the auditor should communicate to the audit committee his or her responsibility for such information,[15/] any related procedures performed, and the results of such procedures.

Management Consultations with Other Accountants

15. When the auditor is aware that management consulted with other accountants about auditing or accounting matters, the auditor should communicate to the audit committee his or her views about significant matters that were the subject of such consultation.[16/]

14/ AU sec. 550, *Other Information in Documents Containing Audited Financial Statements.*

15/ In addition to AU sec. 550, discussion on the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information,* AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents,* and AU sec. 711, *Filings Under Federal Securities Statutes.*

16/ AU sec. 625, *Reports on the Application of Accounting Principles,* includes requirements regarding circumstances in which the auditor should be informed of such consultations.

Going Concern

16. The auditor should communicate to the audit committee, when applicable, certain matters relating to his or her evaluation of a company's ability to continue as a going concern:

a. If conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time[17/] but the auditor's doubt was mitigated, the auditor should communicate those conditions and events as well as the information that mitigated the auditor's doubt;[18/] or

b. If the auditor concludes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the following matters should be communicated:[19/]

   i. The auditor's assessment of management's plans to overcome the conditions and events and management's ability to implement the plans;

   ii. The effects, if any, on the financial statements and the adequacy of the related disclosure; and

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17/ AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* includes requirements regarding an auditor's responsibility to evaluate whether there is substantial doubt about a company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

18/ Paragraph .03a of AU sec. 341 discusses the auditor's evaluation related to when there are factors that indicate there could be substantial doubt about the company's ability to continue as a going concern.

19/ Paragraphs .03b-c of AU sec. 341 discuss the auditor's evaluation related to when there are factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

iii. The effects, if any, on the auditor's report.[20]

Note: These communication requirements apply even when the auditor has concluded that implementation of management's plans mitigate the effects of the conditions or events indicating there is substantial doubt about the company's ability to continue as a going concern.

Corrected and Uncorrected Misstatements

17. The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that was presented to management.[21]

18. The auditor should communicate to the audit committee the basis for the auditor's determination that the uncorrected misstatements were immaterial, including the qualitative[22] factors considered. The auditor also should communicate those corrected misstatements that might not have been detected except through the auditing procedures performed, including the implications such corrected misstatements might have on the financial reporting process.

Note: The auditor should communicate that uncorrected misstatements or matters underlying uncorrected misstatements could cause financial statements to be materially misstated in future periods, even though the auditor has concluded that the uncorrected misstatements are not material to the financial statements for the year under audit.

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[20] Paragraphs .12-.16 of AU sec. 341 discuss the effect on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

[21] See Section 13(i) of the Securities Exchange Act of 1934, which states, in part, that financial statements prepared in accordance with generally accepted accounting principles and filed with the Securities and Exchange Commission "shall reflect all material correcting adjustments that have been identified by a registered public accounting firm …."

[22] Paragraphs .15-.17 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312,* discuss the qualitative characteristics of misstatements.

Departure from the Standard Auditor's Report

19. When the auditor expects to modify the opinion in the auditor's report or to include an explanatory paragraph in the report, the auditor should communicate with the audit committee the reasons for the modification or explanatory paragraph and the proposed wording of the report.

Disagreements with Management

20. The auditor should communicate to the audit committee disagreements with management about matters, whether or not satisfactorily resolved that individually or in the aggregate could be significant to the company's financial statements or the auditor's report.

> Note: Disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved prior to the issuance of the auditor's report.

Difficulties Encountered in Performing the Audit

21. The auditor should communicate any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include:

a. Significant delays by management or an unwillingness by management to provide information needed for the auditor to perform his or her procedures;

b. An unnecessarily brief time within which to complete the audit;

c. Extensive, unexpected effort required to obtain sufficient appropriate audit evidence;

d. Unreasonable restrictions imposed on the auditor by management; and

e. Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested.

Note: Difficulties encountered during the audit could lead to modifying the auditor's opinion on the basis of a scope limitation.[23/]

Other Matters

22. The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process. This communication includes when the auditor is aware of complaints or concerns raised regarding accounting or auditing matters.[24/]

Form and Content of Communications

23. The auditor should communicate to the audit committee the matters in this standard either in writing or orally,[25/] unless otherwise specified in this standard. The auditor should document the communications, whether communicated orally or in writing, in sufficient detail to enable an experienced auditor,[26/] having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

Note: If management communicated matters identified in paragraph 12, the auditor should include a copy of or a summary of management's communications provided to the audit committee in the audit documentation.

23/ See paragraphs .22-.32 of AU sec. 508, *Reports on Audited Financial Statements,* for a discussion on scope limitations.

24/ Paragraphs .79-.82 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* and paragraph .17 of AU sec. 317, *Illegal Acts by Clients,* include specific communication requirements relating to fraud or illegal acts.

25/ See AU sec. 532, *Restricting the Use of an Auditor's Report,* which applies to certain reports on matters coming to the auditor's attention during the course of the audit.

26/ As described in paragraph 6 of AS No. 3, *Audit Documentation,* "[a]n experienced auditor has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

Timing

24. Audit committee communications should occur in a timely manner, unless other timing requirements are specified. The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed.

Note: Communications with the audit committee chair may be appropriate if done in order to communicate matters timely during the audit. The auditor should, at a later date, communicate such matters to the full audit committee.

25. All communications required by this standard should be made annually to the audit committee prior to the issuance of the auditor's report.[27/]

Adequacy of the Two-Way Communications

26. Prior to the issuance of the auditor's report, the auditor should evaluate whether the two-way communications between the auditor and the audit committee have been adequate to support the objectives of the audit. 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:

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

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

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

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

Note: The auditor should read the minutes, if any, relating to audit committee meetings for consistency with the auditor's understanding of the communications.

[27/] Consistent with Rule 2-07 of Regulation S-X, in the case of a registered investment company, if the annual communication is not within 90- days prior to the filing, the auditor should provide an update in the 90-day period prior to the filing, of any changes to the previously reported information.

27. If the auditor determines that the two-way communications have not been adequate, the auditor should evaluate the effects, if any, on his or her assessment of the risks of material misstatement and on his or her ability to obtain sufficient appropriate audit evidence, and should take appropriate action.

> Note: In an integrated audit, the auditor also should include the evaluation of the results of tests of controls related to the control environment regarding the audit committee.[28/]

28. If the auditor determines that the two-way communications between the audit committee and the auditor have not been adequate and the situation cannot be resolved, the auditor should consider taking such actions as:

a. Communicating with the full board of directors;

b. Modifying the auditor's opinion on the basis of a scope limitation;[29/] or

c. Withdrawing from the engagement.

28/ Paragraph 25 of AS No. 5.

29/ Paragraphs .22-.32 of AU sec. 508 discuss scope limitations.

<u>APPENDIX</u> A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Audit committee – a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company.

A3. Critical accounting estimate – an accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and (b) the impact of the estimate on financial condition or operating performance is material.

A4. Critical accounting policies and practices – a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

***APPENDIX* B – Communications with Audit Committees Required by Other PCAOB Standards and Rules**

This appendix identifies paragraphs within other PCAOB standards[1/] and rules that require communication of specific matters by auditors with audit committees.

- PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*
- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* paragraphs .22, and .78 - .81
- AU sec. 317, *Illegal Acts by Clients,* paragraph .17
- AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* paragraphs 4 - 7, and 9
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures,* paragraph .50
- AU sec. 333, *Management Representations,* paragraph .05
- AU sec. 722, *Interim Financial Information*, paragraphs .08, .09, .30, .31, and .33 - .36
- Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* paragraphs 60, 62, and 64

[1/] Paragraph 53 of the Proposed Auditing Standard, *Identifying and Assessing Risks of material Misstatement,* includes additional communication requirements with audit committees.

- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* paragraphs 78 - 80, and 91

Appendix C – Matters Communicated in the Audit Engagement Letter

C1. The auditor should include the following matters in the engagement letter.[1/] The auditor's description of these matters will vary depending on whether the auditor is engaged in a financial statement audit or in an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

a. The objective of the audit is:

   1. Integrated audit: The expression of an opinion on both the effectiveness of internal control over financial reporting and the financial statements.

   2. Audit of financial statements: The expression of an opinion on the financial statements.

b. Auditor's responsibilities:

   1. The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

      a. Integrated audit: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial

[1/] Certain matters should not be included in an engagement letter, e.g., under Section 602.02.f.i. of the Codification of Financial Reporting Policies indemnification provisions are not permissible for audits of issuers.

reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

b. <u>Audit of financial statements:</u> Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

2. An audit includes:

a. <u>Integrated audit:</u> In fulfillment of the responsibilities noted above, the auditor should communicate in writing:

i. To the audit committee and management: all material weaknesses in internal control over financial reporting identified during the audit.

ii. To the audit committee: all significant deficiencies identified during the audit and inform the audit committee when the auditor has informed management of all internal control deficiencies.

iii. To management: all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others within the company.

iv. To the board of directors: any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

b. Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed.[2/] An audit of financial statements is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating in writing:

i. To the audit committee and management: all significant deficiencies and material weaknesses identified during the audit.

ii. To the board of directors: if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

c. Management's responsibilities:

1. Management is responsible for the company's financial statements, including disclosures.

2. Management is responsible for establishing and maintaining effective internal control over financial reporting.

3. Management is responsible for identifying and ensuring that the company complies with the laws and regulations applicable to its activities.

[2/] AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on control deficiencies identified in an audit of financial statements.

4. Management is responsible for making all financial records and relevant information available to the auditor.

5. At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.

6. Management is responsible for adjusting the financial statements to correct material misstatements relating to accounts or disclosures and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

C2. In connection with a review of interim financial information, to confirm and document the understanding, the auditor should either: (a) document in the audit engagement letter the nature and objectives of the engagement to review interim financial information and the responsibilities of management and the auditor or (b) issue a separate engagement letter that addresses such matters.[3/]

[3/] Paragraphs .08 - .09 of AU sec. 722, *Interim Financial Information*, discusses the auditor's responsibilities related to establishing an understanding with the audit committee in connection with a review of the company's interim financial information.

APPENDIX 2

Proposed Amendments to PCAOB Standards

Auditing Standards

AU sec. *310, Appointment of the Independent Auditor*

SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards,* vol. 1, AU sec. 310, "Relationship Between the Auditor's Appointment and Planning," as amended, is superseded.

AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*[1/]

AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312,* is amended as follows –

The last sentence of paragraph .09 is deleted.

AU sec. 316, *Considerations of Fraud in A Financial Statement Audit*[2/]

AU sec. 316, *Considerations of Fraud in A Financial Statement Audit,* is amended as follows –

In the second bullet point in paragraph .50 the reference to section 380, *Communication With Audit Committees,* paragraph .11 is replaced with paragraphs 12-13 of Proposed Auditing Standard, *Communications with Audit Committees.*

1/ PCAOB Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*, includes proposed amendments which would supersede or delete paragraphs for which amendments are included in this proposed standard. If, at the conclusion of the above mentioned rulemaking, the Board adopts amendments which would affect amendments proposed in this standard, the Board will make a conforming change to this proposed standard.

2/ Ibid.

AU sec. 328, *Auditing Fair Value Measurements and Disclosures*

AU sec. 328, *Auditing Fair Value Measurements and Disclosures,* is amended as follows –

AU Paragraph .50 is replaced with -

Paragraphs 12-13 of Proposed Auditing Standard, *Communications With Audit Committees,* require auditors to communicate to the audit committee matters related to certain accounting estimates which include fair value measurements.

AU sec. 333, *Management Representations*

AU sec. 333, *Management Representations,* is amended as follows –

The following sentence is added as the last sentence to paragraph .05 –

> The auditor should provide a copy of the representation letter to the audit committee, if management has not already provided the representation letter to the audit committee.

AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* is amended as follows –

a. A heading after paragraph 17 is added, "Communications with Audit Committees."

b. The following paragraph 17a is added –

> Paragraph 16 of Proposed Auditing Standard, *Communications with Audit Committees*, describes matters an auditor is required to communicate to the audit committee related to the company's ability to continue as a going concern for a reasonable period of time.

AU sec. 380, *Communication with Audit Committees*

SAS No. 61, *Communication with Audit Committees (*AU sec. 380*, Communication with Audit Committees*), as amended, is superseded.

AU sec. 9380, *Communication with Audit Committees: Auditing Interpretations of Section 380*

AU sec. 9380, *Communication with Audit Committees: Auditing Interpretations of Section 380*, is superseded.

AU sec. 532, *Restricting the Use of an Auditor's Report*

AU sec. 532, *Restricting the Use of an Auditor's Report,* is amended as follows –

The reference to Section 380, *Communications With Audit Committees,* in the second bullet point of paragraph .07 is replaced with Proposed Auditing Standard, *Communications with Audit Committees.*

AU sec. 722, *Interim Financial Information*

AU sec. 722, *Interim Financial Information*, is amended as follows –

a. The heading preceding paragraph .08, "Establishing an Understanding With the Client" is replaced with the heading, "Establishing an Understanding With the Audit Committee."

b. Paragraph .08 is replaced with –

   The accountant should establish a mutual understanding of the terms of an engagement to review interim financial information with the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee).[6/] This mutual understanding includes the objective of the review of interim financial information, the responsibilities of the auditor and the responsibilities of management. Such an understanding reduces the risk that either the accountant or the audit committee may misinterpret the needs or expectations of the other party. The accountant should record this understanding of the terms of the engagement in an engagement letter and should provide the engagement letter to the audit committee. If the accountant believes he or she cannot establish a mutual understanding of the terms of an engagement to review interim financial information with the audit committee the accountant should decline to accept or perform the engagement.

c. Footnote 6 to paragraph .08 is replaced with –

See Paragraph 16 of Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

d. In the first sentence of paragraph .09, the word "client" is replaced with the words "audit committee."

e. Paragraph .30 is replaced with –

If management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should communicate these matters to the audit committee as soon as practicable. The communications to the audit committee should be made and documented in accordance with paragraph 23 of Proposed Auditing Standard, *Communications with Audit Committees.*

e. Paragraph .34 is replaced with –

When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in Proposed Auditing Standard, *Communications with Audit Committees,* as they relate to interim financial information, have been identified. If such matters have been identified, the accountant should communicate them to the audit committee. For example, the accountant should communicate a description of the process used by management to develop the critical accounting estimates; a change in a significant accounting policy affecting the interim financial information; misstatements that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and uncorrected misstatements aggregated by the accountant that were determined by management to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole. Management may communicate, as part of its communications to the audit committee, certain matters identified in paragraph 12 of Proposed Auditing Standard, *Communications with Audit Committees,* regarding accounting policies, practices and estimates, in which case the accountant should determine whether all the matters were adequately described and, if not, the accountant should communicate any omitted or inadequately described matters to the audit committee.

f. Paragraph .36 is replaced with –

If the accountant has identified matters to be communicated to the audit committee, the accountant should communicate such matters to the audit committee, or at least its chair, and a representative of management before the entity files its interim financial information with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 23 of Proposed Auditing Standard, *Communications with Audit Committees.*

Quality Control Standards

QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*

QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* is amended as follows –

a. In paragraph .16, in the first sentence the word "client" is replaced with the words "audit committee."

b. The last sentence in paragraph .16 is deleted.

APPENDIX 3

Comparison of the Objectives and Requirements of the Proposed Auditing Standard to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

Introduction

This appendix discusses certain significant differences between the objectives and requirements of the accompanying proposed standard in this release and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and analogous standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants. The comparable IAASB standards are International Standard on Auditing ("ISA") 210, *Agreeing the Terms of the Audit Engagements*, and ISA 260, *Communication with those Charged with Governance*. The comparable ASB standards are proposed Statement on Auditing Standard ("SAS"), *Terms of Engagement* and SAS 114, *The Auditor's Communication with Those Charged with Governance*,.[1/] The analysis does not cover the application and explanatory material in the IAASB standards or ASB standards.[2/]

[1/] Other proposed or adopted standards of the IAASB and the ASB, including ISA 570, *Going Concern,* ISA 450, *Evaluation of Misstatements Identified During the Audit,* ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors),* ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements,* the Proposed SAS, *Evaluation of Misstatements Identified During the Audit,* the Proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)* and the Proposed SAS, *Other Information in Documents Containing Audited Financial Statements,* were considered in this comparison to the extent they include comparable requirements.

[2/] Paragraph A59 of International Standard on Auditing ("ISA") 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* indicates that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of the Proposed SAS, *Overall Objectives of the Independent Auditor and the Conduct of*

This appendix is provided for informational purposes only. It is not a substitute for the proposed standard itself, which is presented in Appendix 1 of this release.

This analysis may not represent the views of the IAASB or ASB regarding the interpretation of their standards.

Objectives of the Auditor

PCAOB

The Board's proposed standard would replace AU sec. 310, *Appointment of the Independent Auditor*, ("AU sec. 310"), and AU sec. 380, *Communication with Audit Committees* ("AU sec. 380"). Those standards were written before the Sarbanes-Oxley Act of 2002 (the "Act") when management of a listed company, rather than the audit committee, was often responsible for engaging and overseeing the auditor. Given the responsibility of many audit committees for the appointment and retention of the auditor, the proposed standard combines the requirements from the Board's interim standards, AU secs. 310 and 380, into one auditing standard. Accordingly, the objectives in the proposed standard reflect both the appointment and retention of the auditor as well as the overall communication responsibilities. The objective for the auditor to establish a mutual understanding of the terms of the audit engagement with the audit committee was included as the audit committee, not management, should be the primary contact for the auditor of issuers with respect to matters regarding oversight of the audit. The proposed standard has an additional objective 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. The proposed standard includes this objective due to the importance of the relationship between the auditor and the audit committee.

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an Audit in Accordance with Generally Accepted Auditing Standards, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU section."

IAASB and ASB

ISA 210 and the Proposed SAS, *Terms of Engagement* ("Proposed SAS"), both include an objective to establish whether the preconditions for an audit are present. The proposed standard does not include this objective, because some of the related requirements in ISA 210 and in the Proposed SAS are not applicable to the audits of issuers. To the extent these related requirements are applicable they are included as requirements in the proposed standard for establishing a mutual understanding of the terms of the audit engagement with the audit committee.

Both ISA 260 and SAS 114 include an objective for the auditor to promote effective two-way communication between the auditor and those charged with governance, although the standards do not impose related requirements to promote effective two-way communications. Rather, ISA 260 and SAS 114 include a requirement for the auditor to evaluate the adequacy of the two-way communications. The proposed standard includes an objective to evaluate the adequacy of the two-way communications, and includes a requirement similar to the ISA and SAS to evaluate the adequacy of the communication process.

Significant Issues Discussed with Management Prior to the Appointment or Retention

PCAOB

The proposed standard retains the requirement for the auditor to discuss with the audit committee any significant issues that were discussed with management in connection with the appointment or retention of the auditor, including any discussions regarding the application of accounting principles and auditing standards. Section 301 of the Act and Securities and Exchange Commission ("SEC") rules require that audit committees of companies with securities listed on a national exchange or with a national securities association be directly responsible for the appointment, compensation, and oversight of the work of the auditors. However, even when ultimate authority rests with the audit committee, management may have discussions with the auditor regarding the application of accounting principles or auditing standards prior to the initial appointment or retention of the auditor, and as such, the proposed standard retains this requirement from AU sec. 380.

IAASB and ASB

ISA 260 and SAS 114 do not include a similar requirement.

Establish a Mutual Understanding of the Terms of the Audit

PCAOB

The proposed standard requires the auditor to establish a mutual understanding of the terms of the audit engagement with the audit committee in connection with the audit. This mutual understanding includes communicating to the audit committee the objective of the audit, the responsibilities of the auditor, and the responsibilities of management similar to AU sec. 310. The proposed standard requires this mutual understanding of the terms of the audit engagement be established with the Audit Committee rather than with management, since Section 301 of the Act and SEC rules require that audit committees of companies with securities listed on a national exchange or with a national securities association be directly responsible for the appointment and retention of the auditors.

The proposed standard requires the terms of the audit engagement to include the objective of the audit, the responsibilities of the auditor, and the responsibilities of management in a written in an engagement letter similar to ISA 210 and the Proposed SAS. The proposed standard also requires the auditor to provide the engagement letter to the audit committee.

IAASB and ASB

ISA 210 and the Proposed SAS require the auditor to agree on the terms of the audit engagement with management or those charged with governance, as appropriate.

ISA 210 and the Proposed SAS require the engagement letter to be in writing, although there is no requirement that the engagement letter be given to the audit committee. Additionally, ISA 210 and the Proposed SAS state that for recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The proposed standard requires a written engagement letter to be provided to the audit committee annually.

Both ISA 210 and the Proposed SAS also establish requirements for the auditor to determine whether the preconditions for an audit exist. The proposed standard does not include similar requirements as these requirements were either not applicable to the audits of issuers or were addressed through the requirements in the proposed standard for establishing a mutual understanding of the terms of the audit engagement with the audit committee.

ISA 210 includes requirements regarding financial reporting standards supplemented by law or regulation as well as requirements regarding the financial reporting framework. The Proposed SAS does not include similar requirements. The proposed standard also does not include similar requirements as they are not relevant to the audits of issuers.

ISA 210 and the Proposed SAS also include requirements regarding limitation of scope prior to audit engagement acceptance, other factors affecting audit engagement acceptance, and acceptance of a change in the terms of the audit engagement. The proposed standard does not include such requirements as they are not applicable to the audits of issuers.

The Proposed SAS also includes requirements regarding initial audits and re-audits. The proposed standard does not include similar requirements, although similar requirements are included in the Board's interim standard, AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

Additionally, ISA 260 and SAS 114 include a requirement for the auditor to communicate with those charged with governance the form, timing, and expected general content of communications. The proposed standard does not include this requirement, although the proposed standard does not preclude the auditor from communicating other matters to the audit committee.

Obtaining Information Related to the Audit

PCAOB

The proposed standard requires the auditor to inquire of the audit committee about whether they are aware of other matters that may be related to the audit, including complaints or concerns raised regarding accounting or auditing matters. The Board's Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* includes a requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks.[3/] The requirement in the proposed standard complements the requirement in the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

IAASB and ASB

ISA 260 and SAS 114 do not contain a similar requirement.

Audit Strategy and Timing of the Audit

PCAOB

The proposed standard requires the auditor to communicate to the audit committee an overview of the audit strategy, including a discussion of the significant risks identified during the risk assessment procedures as well as the timing of the audit. The auditor also should communicate the following matters to the audit committee, if applicable: a) the auditor's determination of whether persons with specialized skill or knowledge are needed to apply the planned audit procedures or evaluate the audit results; b) the auditor's consideration of the planned use of the company's internal audit function, third parties or others within the company; c) the roles, responsibilities, and locations of firms participating in the audit, and d) the basis for the auditor's determination that he or she can serve as principal auditor. In addition, the auditor should communicate to the audit committee significant changes to the planned audit strategy and the significant risks initially identified.

These communications are intended to provide the audit committee with insight into the auditor's evaluation of risk and approach to the audit. The proposed standard includes these communication requirements to address instances where the auditor uses the assistance of other firms to perform audit procedures. Communication of these arrangements to the audit committee provides information regarding the parties involved in the audit who will perform audit procedures that the auditor will evaluate as part of the consideration of whether sufficient appropriate audit evidence has been obtained. Communication of the roles, responsibilities, and locations of firms participating in the

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[3/] Paragraph 51 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

audit also facilitates an effective discussion of how the work of other parties affects the audit.

IAASB and ASB

Similar to the proposed standard, ISA 260 and SAS 114 require the auditor to communicate an overview of the planned scope and timing of the audit. However, ISA 260 and SAS 114 do not require the auditor to communicate significant changes to the planned scope and timing of the audit, which is required in the proposed standard. Further, ISA 260 and SAS 114 do not include requirements for the auditor to communicate information about the use of other auditors. ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors),* and the Proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, includes requirements for the auditor to communicate certain matters to those charged with governance including: an overview of the type of work to be performed on the financial information of the components; an overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components; and instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of the auditor's work.

Accounting Policies, Practices and Estimates

PCAOB

The proposed standard expands on the requirements in AU sec. 380 regarding communication requirements relating to accounting policies, practices, and estimates. Similar to AU sec. 380, the proposed standard acknowledges that management may communicate matters relating to the financial reporting process. However, the proposed standard requires the auditor to determine whether the matters were adequately described by management, and if not, the auditor should communicate any omitted or inadequately described matters to the audit committee.

The proposed standard requires the auditor to communicate the results of his or her evaluation of the quality, clarity and completeness of the company's financial statements, including related disclosures. This requirement is similar to the requirement in AU sec. 380, which requires the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability of the company's accounting principles.

The proposed standard also includes requirements consistent with those in Rule 2-07 of Regulation S-X[4/] for the auditor to communicate critical accounting policies and practices directly to the audit committee as well as alternative treatments within the applicable financial reporting framework for policies and practices related to material items discussed with management. These requirements may assist the auditor in complying with all of the required accounting related communications to the audit committee, including those imposed by the SEC.

The proposed standard includes a new requirement for the auditor to communicate, or evaluate management's communication to the audit committee, of the anticipated application of new accounting or regulatory pronouncements that are not yet effective, but which may, upon adoption, have a significant effect on the company's financial reporting. The auditor may develop a view regarding changes to processes or systems that could impact the financial reporting process that would not be included in management's disclosures in the financial statements, but which the auditor may wish to communicate to the audit committee. A discussion of such matters in more detail with the audit committee may allow audit committees time to properly consider the effects on future financial statements as well as ramifications on the financial reporting process.

The proposed standard includes a requirement for the auditor to communicate to the audit committee significant accounting matters for which the auditor has consulted outside the engagement team, as this may provide the audit committee with additional information on accounting matters that may pose more risk to the financial statements.

The proposed standard defines the term "critical accounting estimate" as an accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and (b) the impact of the estimate on financial condition or operating performance is material. The proposed standard uses the term critical accounting estimate to help focus the communication to the audit committee on those estimates that are subject to a higher risk of material misstatement.

Further, the proposed standard includes new requirements for the auditor to communicate, or to evaluate whether management has adequately communicated, the following matters:

a. How management subsequently monitors critical accounting estimates;

[4/] 17 CFR 210.2-07.

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

c. 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

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

In addition, the proposed standard requires the auditor to communicate his or her 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.

If the auditor determines that potential bias exists in management's accounting estimates, the proposed standard requires the auditor to communicate this determination.

IAASB and ASB

ISA 260 and SAS 114 require the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures and when applicable, to communicate why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstance of the entity. ISA 260 and SAS 114 do not address the auditor's communication responsibilities when management has communicated accounting matters to the audit committee.

Other Information in Documents Containing Audited Financial Statements

PCAOB

The proposed standard carries forward the requirement from AU sec. 380 for the auditor to communicate his or her responsibility when other information is presented in documents containing audited financial statements, any related procedures performed, and the results of such procedures. The proposed standard includes this requirement since the auditor's report is included in filings with the SEC that contain financial information outside of the financial statements (i.e., Form 10-K section on "Management's Discussion and Analysis").

IAASB and ASB

ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements,* requires the auditor to notify those charged with governance if there is a material misstatement of fact in the other information which management refuses to correct. The proposed SAS, *Other Information in Documents Containing Audited Financial Statements,* contains a similar requirement to the Board's proposed standard.

Management Consultations with Other Accountants

PCAOB

The proposed standard incorporates the requirement from AU sec. 380 for the auditor to discuss with the audit committee when the auditor is aware that management has consulted with other accountants about auditing or accounting matters. In such case, the auditor should discuss his or her views about significant matters that were the subject of such consultation.[5/] This communication was included in the proposed standard as the audit committee should be aware of issues which may affect the current or future financial statements and which may have implications to the audit.

IAASB and ASB

The ISA does not include a similar requirement. SAS 114 includes a similar requirement to the proposed standard.

[5/] AU sec. 625, *Reports on the Application of Accounting Principles,* discusses the circumstances in which the auditor should be informed of such consultations.

Going Concern

PCAOB

As part of the audit, the auditor has a responsibility to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[6/] The proposed standard includes a requirement for the auditor to communicate to the audit committee, when applicable, certain matters regarding the auditor's evaluation of the company's ability to continue as a going concern.

IAASB and ASB

The IAASB includes a similar requirement in ISA 570, *Going Concern*. The ASB does not have a similar requirement.

Corrected and Uncorrected Misstatements

PCAOB

The proposed standard requires the auditor to provide the audit committee with the same schedule of uncorrected misstatements related to accounts and disclosures presented to management, rather than a summary of the uncorrected misstatements, so as not to misrepresent the nature of the underlying differences when considered individually. The proposed standard also requires the auditor to communicate the basis for the auditor's determination that the uncorrected misstatements were immaterial, including the qualitative factors considered. The auditor also should communicate those corrected misstatements that might not have been detected except through the auditing procedures performed, including the implications such corrected misstatements might have on the financial reporting process.

IAASB and ASB

SAS 114 requires the auditor to communicate uncorrected misstatements and the effect that they may have on the auditor's report. Unlike the proposed standard, the SAS requires that the auditor request that uncorrected misstatements be corrected

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[6/] Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

and to communicate the effect of the uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. The proposed standard does not include the requirement to request management to correct the misstatements. However, for audits of issuers, management represents to the auditor in the management representation letter that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[7/]

ISA 450, *Evaluation of Misstatements Identified During the Audit,* includes requirements for the auditor to communicate uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. Similar to the SAS, ISA 450 also requires the auditor to request that uncorrected misstatements be corrected. The auditor also is required to communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

ISA 450 and SAS 114 do not include a requirement to communicate corrected misstatements.

Timing

PCAOB

The proposed standard requires the communications required by the standard to be made annually and prior to the issuance of the auditor's report.[8/] The importance of the auditor's audit committee communications to help achieve the objectives of the audit supports that these communications occur prior to the issuance of the auditor's report. This is consistent with the required timing of communications to the audit committee required by the SEC. Further, while an annual communication may require the repetition

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[7/] See paragraph .06 g. of AU sec. 333, *Management Representations.*

[8/] The proposed standard includes the following exception for registered investment companies: consistent with Rule 2-07 of Regulation S-X, in the case of a registered investment company, if the annual communication is not within 90 days prior to the filing, the auditor should provide an update, in the 90 day period prior to the filing, of any changes to the previously reported information.

of certain matters, the importance of those matters merits a yearly discussion as views and circumstances may change.

IAASB and ASB

ISA 260 and SAS 114 require that the auditor should communicate with those charged with governance on a timely basis.

Other Matters

PCAOB

The proposed standard includes a requirement for the auditor to communicate other matters arising from the audit that are significant to the oversight of the financial reporting process. This communication includes when the auditor is aware of complaints or concerns raised regarding accounting or auditing matters. This new requirement is included to acknowledge that there are other matters that are not addressed by specific communication requirements in the proposed standard that may be beneficial to the financial reporting process.

IAASB and ASB

ISA 260 and SAS 114 include a similar requirement for the auditor to communicate other matters to the audit committee that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.