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Public Company Accounting Oversight Board

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STANDING ADVISORY GROUP MEETING

AUDITOR'S REPORTING MODEL

NOVEMBER 15-16, 2012

Introduction

The auditor's report is the primary means by which the auditor communicates to investors and other users of financial statement information regarding his or her audits of a company's financial statements. The auditor's report has changed little since the 1940s. Several commissions recommended changes to the auditor's report in the 1970s and 1980s.[1/] More recently, members of the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Standing Advisory Group ("SAG") and Investor Advisory Group suggested, and the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession recommended, that the PCAOB undertake a standard-setting initiative to consider improvements to the auditor's reporting model.[2/] Additionally, many investors have said that the auditor's report is too "boilerplate" and that the form of the auditor's report limits the information provided about the significant matters in the financial statements or the audit.

In 2010 the Board initiated a project to consider improvements to the auditor's reporting model. In addition to the PCAOB's project, other regulators and standard setters, such as the European Union ("EU"), the International Auditing and Assurance

[1/] For example, the Commission on Auditors' Responsibilities (known as the "Cohen Commission") and the National Commission on Fraudulent Financial Reporting (known as the "Treadway Commission").

[2/] U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (Oct. 6, 2008), at VII:13, available at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

Standards Board ("IAASB"), and the UK Financial Reporting Council ("FRC") have been working on similar projects.

This paper provides SAG members with a brief description of the PCAOB's activities related to the auditor's reporting model. It also describes other regulators' and standard-setters' projects related to auditor reporting, which could inform the PCAOB's project. The paper then discusses a potential approach for the PCAOB's project that takes into account the auditor's communication requirements to the audit committee.

At the November 2012 SAG meeting, SAG members will be asked for their views regarding the PCAOB's potential approach to enhancing the communicative value of the auditor's report, as well as whether the PCAOB should consider elements of the approaches taken by other regulators and standard setters. After a brief introduction of the topic, SAG members and observers will form break-out groups to discuss specific questions regarding the topic. On the second day of the meeting, PCAOB staff will present a summary of the break-out group discussions, and SAG members will have an opportunity to provide additional commentary.

PCAOB Activities

On June 21, 2011 the Board issued a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").[3/] The objective of the concept release was to discuss several alternatives for changing the auditor's reporting model in order to make auditor reporting more relevant and useful to investors and other financial statement users. The alternatives presented were (1) an auditor's discussion and analysis; (2) required and expanded use of emphasis paragraphs; (3) auditor assurance on other information outside the financial statements; and (4) clarification of the standard auditor's report.

The Board received 155 comment letters on the concept release.[4/] Additionally, on September 15, 2011, the Board held a public roundtable[5/] to obtain insight from a

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[3/] *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011-003 (June 21, 2011) available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

[4/] Comment letters on the concept release are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket034Comments.aspx.

[5/] A transcript of the roundtable is available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

diverse group of investors and other financial statement users, preparers of financial statements, audit committee members, and auditors on the alternatives presented in the concept release for changing the auditor's reporting model. The topic was further discussed at the November 2011 SAG meeting[6/] when staff members of the Office of the Chief Auditor ("staff") presented a summary of comments received.

The comments on the concept release and at the roundtable indicate diverse views among different constituencies. Preparers and audit committee members generally do not support significant change in auditor reporting and believe it is the responsibility of management or the audit committee, not the auditors, to provide any information about the company's financial statements to financial statement users. Auditors generally are supportive of certain changes to the auditor's report but believe that any additional reporting must be objective and factual.

Investors strongly support change to the auditor's report to improve its informational value. Investors most frequently suggest additional auditor reporting on the following information:

- Areas of high risk to the financial statements and the audit;
- The most significant matters in the financial statements, such as significant management judgments, estimates and areas with significant measurement uncertainty;
- The quality of the company's accounting policies and practices; and
- Significant changes in, or events affecting, the financial statements, including unusual transactions.

The PCAOB is in the process of considering comments received on the concept release and developing a proposal for public comment.

6/ A transcript of the portion of the SAG meeting related to the concept release is available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf.

Other Regulators' and Standard-setters' Activities

Other regulators and standard setters have publicly proposed or requested comment on their auditor reporting projects.

European Union

In November 2011, the European Commission ("EC") introduced proposed legislation that relates to audits of public interest entities.[7/] Article 22 of the EC's proposed regulation includes requirements for the auditor's report. Under the EC proposal, the content of the auditor's report would be expanded to include the following new items, among others:[8/]

a. The date of the appointment and the period of uninterrupted audit engagement;

b. The methodology used in conducting the audit, including how much of the balance sheet has been directly verified and how much has been based on system and compliance testing, and an explanation of any variation in the weighting of substantive and compliance testing when compared to the previous year;

c. The levels of materiality applied to perform the audit;

d. The key areas of risk of material misstatements of the financial statements, including critical accounting estimates or areas of measurement uncertainty;

e. A statement on the assessment of the company's ability to continue as a going concern for the foreseeable future;

[7/] *See* Article 22 of proposal for a *Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities* (Nov. 30, 2011) at http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf.

[8/] Other items of the proposed legislation are not listed because they are similar to matters currently reported by the auditor under the standards of the PCAOB or because they are not applicable to the audits of issuers.

f. The extent to which the audit was designed to detect irregularities, including fraud;

g. Any violations of accounting rules or laws;

h. A statement that the audit opinion is consistent with the additional report to the audit committee;

i. A statement that the auditor remained completely independent in conducting the audit, in addition to certain information regarding non-audit services;

j. An opinion regarding whether the financial statements give a true and fair view and have been prepared in accordance with the relevant financial reporting framework;

k. Matters to which the auditor(s) or the audit firm(s) draw attention by way of emphasis without qualifying the audit opinion; and

l. An opinion regarding the consistency of the annual report with the financial statements for the same fiscal year.

The EC's proposal is advancing through the EU's legislative process starting with the European Parliament to be followed by the Council of Member States. In September 2012, the lead manager in the Parliament (the "Rapporteur") introduced at the committee level a counter-proposal containing amendments to the EC's proposal.[9/] This counter-proposal includes deletions of items b, c, d, f, and g above; changes to the other items identified above, except item h; and addition of the following new items:

- A description of the most important assessed risks of material misstatement, a summary of the auditor's response, key observations from the related audit work, and a reference to the relevant disclosures in the financial statements; and

[9/] The draft report of the European Parliament's Committee on Legal Affairs is available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-494.551%2b02%2bDOC%2bPDF%2bV0%2f%2fEN.

- The information related to the most important assessed risks of material misstatement should be selected from the matters discussed with the audit committee.

Other members of the committee also are expected to propose amendments to be published in November 2012. At the same time, the Rapporteur, the Council, and the Commission are in active negotiations on a possible compromise. There is no indication of when the EU's legislative process would be finalized but consideration by the full Parliament is not expected until 2013.

IAASB

The IAASB is also in the process of working on a project on auditor reporting. In June 2012, the IAASB issued a document entitled *Invitation to Comment: Improving the Auditor's Report,*[10/] ("Invitation to Comment") to obtain public comment on the IAASB's potential direction for the auditor's report. Key changes to the auditor's report discussed in the Invitation to Comment include:

- Matters that, in the auditor's judgment, are likely to be most important to users' understanding of the audited financial statements or the audit, referred to as "Auditor Commentary";

- Auditor conclusion on the appropriateness of management's use of the going concern assumption in preparing the financial statements and an explicit statement as to whether material uncertainties in relation to going concern have been identified;

- Auditor statement as to whether any material inconsistencies between the audited financial statements and other information have been identified based on the auditor's reading of other information, and specific identification of the information considered by the auditor; and

- Enhanced description of the responsibilities of the auditor and key features of the audit itself, and changes to the format of the report.

[10/] The IAASB's June 2012 Invitation to Comment is available at http://www.ifac.org/sites/default/files/publications/files/Auditor_Reporting_Invitation_to_Comment-final_0.pdf.

In September and October 2012, the IAASB held three roundtables to obtain additional comments on the Invitation to Comment. At the SAG meeting, an IAASB representative will provide a brief overview of the current status of the IAASB's project, including highlights of feedback received to date.

FRC

In September 2012, the FRC concluded the consultation process on its *Effective Company Stewardship* project[11/] and issued revised auditing standards intended to enhance auditor reporting.[12/] Under the revised auditing standards, the auditor is required to report, by exception, in the auditor's report if the board's statement[13/] is inconsistent with the knowledge acquired by the auditor in the course of performing the audit. The auditor would also report if the matters disclosed in the report from the audit committee[14/] do not appropriately address matters communicated by the auditor to the committee. The FRC's revised auditing standards are effective for audits of financial statements for periods beginning on or after October 1, 2012.

PCAOB Potential Approach to Auditor Reporting

As previously noted, investors who commented to the PCAOB most frequently suggested additional auditor reporting on the following information:

- Areas of high risk to the financial statements and the audit;

11/ The FRC's *Effective Company Stewardship* project is described at http://www.frc.co.uk/Our-Work/Headline-projects/Effective-company-stewardship.aspx.

12/ The FRC's revised auditing standards are available at http://www.frc.co.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-issues-revised-auditing-standards-to-enhance-c.aspx.

13/ Under the FRC Corporate Governance Code, company boards are required to state that the annual report and accounts taken as a whole are fair, balanced, and understandable and provide the information necessary for shareholders to assess the company's performance, business model and strategy.

14/ Under the FRC Corporate Governance Code, audit committees are required to provide additional information in the annual report on how they have carried out their responsibilities, including how they have assessed the effectiveness of the external audit process.

- The most significant matters in the financial statements, such as significant management judgments, estimates and areas with significant measurement uncertainty;

- The quality of the company's accounting policies and practices; and

- Significant changes in or events affecting the financial statements, including unusual transactions.

These matters generally are communicated to the company's audit committee by the auditor. Therefore, several commenters on the concept release indicated that information communicated to the audit committee also should be communicated to investors through the auditor's report. Auditing Standard No. 16, *Communications with Audit Committees,* which the Board adopted in August 2012,[15/] requires the auditor to communicate to the audit committee many of the matters suggested by investors to be included in the auditor's report.[16/] Auditing Standard No. 16 is designed to enhance the relevance and quality of the communications between the auditor and the audit committee.

A potential approach to the PCAOB's auditor's reporting model project could be to consider the matters communicated to the audit committee under Auditing Standard No. 16 as a basis for enhancements to the auditor's report through required emphasis paragraphs related to the financial statements.[17/] SAG members are asked to consider the following matters related to the financial statements that are communicated to the audit committee under Auditing Standard No. 16 in relation to such an approach:

- Significant risks identified during the auditor's risk assessment procedures;

- Significant accounting policies and practices, including:

[15/] Auditing Standard No. 16 will be effective for audits of fiscal years beginning on or after December 15, 2012, subject to approval by the Securities and Exchange Commission.

[16/] *See* Appendix 1 for Auditing Standard No. 16.

[17/] Emphasis paragraphs as described in current PCAOB standards are not required and may be added solely at the auditor's discretion.

- Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period;
- Effect on financial statements or disclosures of policies in controversial areas or areas for which there is a lack of authoritative guidance or consensus, or diversity in practice;

- Critical accounting policies and practices, including:
    - Reasons certain policies and practices are considered critical;
    - How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical;
- Critical accounting estimates, including:
    - Description of the process management used to develop the estimates;
    - Management's significant assumptions used in the estimates that have a high degree of subjectivity;
    - Significant changes management made to the process used to develop the estimates or significant assumptions;
- Significant unusual transactions, including policies and practices that management used to account for such transactions and the auditor's understanding of the business rationale for such transactions;
- The auditor's evaluation of the qualitative aspects of significant accounting policies and practices;
- The auditor's assessment of the management's disclosures related to the critical accounting policies and practices;
- The basis for the auditor's conclusions regarding critical accounting estimates;
- The auditor's evaluation of the financial statement presentation;

- Alternative accounting treatments permissible under the applicable financial reporting framework for policies and practices related to material items;

- Difficult or contentious matters for which the auditor consulted outside the engagement team;

- The auditor's evaluation of the company's ability to continue as a going concern;

- Uncorrected misstatements and corrected misstatements that might not have been detected except through the auditing procedures;

- Disagreements with management about matters that individually or in the aggregate could be significant to the company's financial statements; and

- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Discussion Questions

1. What matters communicated to the audit committee under Auditing Standard No. 16 would be appropriate for the auditor to communicate in the auditor's report through emphasis paragraphs and why? What matters would not be appropriate and why? For instance, should emphasis paragraphs only relate to financial statement matters or also relate to auditing matters, such as audit strategy?

2. If it is appropriate for matters communicated to the audit committee under Auditing Standard No. 16 to be emphasized in the auditor's report -

   a. Should there be certain matters communicated to the audit committee that are required to be included in the auditor's report? Should there be certain matters communicated to the audit committee that are included in the auditor's report at the auditor's discretion?

   b. If the matters to be included in the auditor's report were at the auditor's discretion, what factors should the auditor consider in determining which matters are most important to financial statement users?

3. If the matters communicated to the audit committee were used as a basis for the matters to be emphasized in the auditor's report, what is the appropriate level of detail that should be provided in the emphasis paragraphs? For instance, should the information in the emphasis paragraphs describe the information provided in the financial statements or also include factual and objective information not in the financial statements?

4. Should there be any special reporting considerations for audits of smaller and less complex companies, brokers and dealers, and emerging growth companies?

5. Are there specific elements of the projects of other regulators or standard-setters that the PCAOB should consider for its auditor's reporting model project?

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

APPENDIX 1

PCAOB
AUDITING STANDARD No. 16*

COMMUNICATIONS WITH AUDIT COMMITTEES

* The standard is presented without appendices B and C.

This paper was developed by the staff of the Office of the Chief Auditor as of November 2, 2012, to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

Auditing Standard No. 16

Communications with Audit Committees

Introduction

1. This standard requires the auditor to communicate with the company's **audit committee**[1/] regarding certain matters related to the conduct of an audit[2/] and to obtain certain information from the audit committee relevant to the audit. This standard also requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee and to record that understanding in an engagement letter.

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

Objectives

3. The objectives of the auditor are to:

   a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;

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

2/ For purposes of this standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

3/ *See e.g.,* Section 10A(k) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j-1(k); Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. § 240.10A-3.

b. Obtain information from the audit committee relevant to the audit;

c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and

d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

> Note: "Communicate to," as used in this standard, is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

Appointment and Retention

Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention

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

Establish an Understanding of the Terms of the Audit

5. The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:

a. The objective of the audit;

b. The responsibilities of the auditor; and

c. The responsibilities of management.

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 annually. The auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company.[4/] If the appropriate party or

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[4/] Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

> Note: Appendix C describes matters that the auditor should include in the engagement letter about the terms of the audit engagement.

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

Obtaining Information and Communicating the Audit Strategy

Obtaining Information Relevant to the Audit

8. The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit,[5/] including, but not limited to, violations or possible violations of laws or regulations.[6/]

Overall Audit Strategy, Timing of the Audit, and Significant Risks

9. The auditor should communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit,[7/] and discuss with the audit committee the significant risks identified during the auditor's risk assessment

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[5/] In addition to this inquiry, paragraphs 5.f. and 54-57 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* describe the auditor's inquiries of the audit committee, or equivalent (or its chair) regarding the audit committee's knowledge of the risks of material misstatement, including fraud risks. These inquiries include, among other things, whether the audit committee is aware of tips or complaints regarding the company's financial reporting.

[6/] *See* AU sec. 317, *Illegal Acts by Clients*, for a description of the auditor's responsibilities when a possible illegal act is detected. For audits of issuers, *see also* Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and Rule 10A-1 under the Exchange Act, 17 C.F.R. § 240.10A-1.

[7/] *See* paragraphs 8-9 of Auditing Standard No. 9, *Audit Planning,* for a description of the auditor's responsibilities for establishing an overall audit strategy.

procedures.[8/]

Note: This overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures.

10. As part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;[9/]

b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;[10/]

c. 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 the audit committee when performing an audit of internal control over financial reporting;[11/]

[8/] Auditing Standard No. 12 requires the auditor to determine whether identified and assessed risks are significant risks. A significant risk is defined as a risk of material misstatement that requires special audit consideration.

[9/] *See* paragraph 16 of Auditing Standard No. 9 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

[10/] *See* AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* which describes the auditor's responsibilities related to the work of internal auditors.

[11/] *See* 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,* which describe the auditor's responsibilities related to using the work of others in an audit of internal control over financial reporting.

d. The names, locations, and planned responsibilities[12/] of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

> Note: The term "other independent public accounting firms" in the context of this communication includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.[13/]

11. The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.[14/]

Results of the Audit

Accounting Policies and Practices, Estimates, and Significant Unusual Transactions

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

a. Significant accounting policies and practices.[15/]

[12/] *See* paragraphs 8-14 of Auditing Standard No. 9, which discuss the auditor's responsibilities for determining the audit strategy, audit plan, and extent to which audit procedures should be performed at selected locations or business units involving multi-location engagements.

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

[14/] *See* paragraph 15 of Auditing Standard No. 9, which discusses changes in audit strategy and the audit plan during the course of the audit.

[15/] *See, e.g.*, Financial Accounting Standards Board Accounting Standards Codification, Topic 235, Notes to Financial Statements, paragraph 235-10-50-1, which requires the entity to disclose a description of all significant accounting policies as an

(1) Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and

(2) The effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

b. **Critical accounting policies and practices**. All critical accounting policies and practices to be used, including:[16/]

(1) The reasons certain policies and practices are considered critical; and

(2) How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

> Note: Critical accounting policies and practices, as defined in Appendix A, are 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. Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year.

c. **Critical accounting estimates**.

(1) A description of the process management used to develop critical accounting estimates;[17/]

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integral part of the financial statements, and paragraph 235-10-50-3, which describes what should be disclosed.

[16/] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), and Rule 2-07(a)(1) of Regulation S-X, 17 C.F.R. § 210.2-07(a)(1).

(2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;[18] and

(3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.[19]

d. Significant unusual transactions.

(1) Significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature;[20] and

(2) The policies and practices management used to account for significant unusual transactions.

> Note: As part of its communications to the audit committee, management might communicate some or all of the matters in paragraph 12. If management communicates any of these matters, the auditor does not need to communicate them at the same level of detail as management, as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor should communicate any omitted or

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[17] *See* AU sec. 342, *Auditing Accounting Estimates*, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

[18] *Id.*

[19] *Id.*

[20] *See* paragraph 71.g. of Auditing Standard No. 12.

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. Qualitative aspects of significant accounting policies and practices.

(1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements;[21/] and

(2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.[22/]

b. Assessment of critical accounting policies and practices. The auditor's assessment 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 management did not make.

c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.[23/]

[21/] *See* paragraphs 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*, which describe the auditor's responsibilities related to evaluating the qualitative aspects of the company's accounting practices.

[22/] *See* paragraph 27 of Auditing Standard No. 14.

[23/] *See* AU sec. 342, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

d. Significant unusual transactions. The auditor's understanding of the business rationale for significant unusual transactions.[24/]

e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth.[25/]

f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.

g. Alternative accounting treatments. All 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 disclosures and treatments and the treatment preferred by the auditor.[26/]

Other Information in Documents Containing Audited Financial Statements

14. When other information is presented in documents containing audited financial statements, the auditor should communicate to the audit committee the auditor's

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24/ *See* paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

25/ *See* paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibilities related to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Other PCAOB standards, such as AU sec. 334, *Related Parties,* and AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describe the auditor's responsibilities related to evaluation of specific disclosures in financial statements.

26/ *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), and Rule 2-07(a)(2) of Regulation S-X, 17 C.F.R. § 210.2-07(a)(2).

responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.[27/]

Difficult or Contentious Matters for which the Auditor Consulted

15. The auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

Management Consultation with Other Accountants

16. When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation.

Going Concern

17. The auditor should communicate to the audit committee, when applicable, the following matters relating to the auditor's evaluation of the company's ability to continue as a going concern: [28/]

a. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt;[29/]

[27/] *See, e.g.*, AU sec. 550, *Other Information in Documents Containing Audited Financial Statements.* In addition to AU sec. 550, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information,* and AU sec. 711, *Filings Under Federal Securities Statutes.*

[28/] *See* AU sec. 341 for the 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. Additionally, AU secs. 341.03a-c provide the auditor with an overview of the requirements for evaluating whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[29/] *See* AU sec. 341.06, which provides examples of such conditions and events and AU sec. 341.07, which discusses the auditor's procedures if the auditor

b. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events;[30/]

c. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:[31/]

(1) The effects, if any, on the financial statements and the adequacy of the related disclosure;[32/] and

(2) The effects on the auditor's report.[33/]

Uncorrected and Corrected Misstatements

18. The auditor should provide the audit committee with the schedule of uncorrected

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believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[30/] *See* AU sec. 341.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

[31/] *See* AU sec. 341.12, which describes the effects on the auditor's report. *See also* AU sec. 341.03c, which discusses the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

[32/] *See* AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

[33/] *See* AU secs. 341.12-.16, which discuss the auditor's consideration of the effects 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.

misstatements related to accounts and disclosures[34/] that the auditor presented to management.[35/] The auditor should discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors[36/] considered. The auditor also should communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

19. The auditor should communicate to the audit committee those corrected misstatements, other than those that are clearly trivial,[37/] related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

Material Written Communications

20. The auditor should communicate to the audit committee other material written communications between the auditor and management.[38/]

[34/] Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include omission and presentation of inaccurate or incomplete disclosures.

[35/] *See* Section 13(i) of the Exchange Act, 15 U.S.C.§ 78m(i), 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 …."

[36/] Appendix B of Auditing Standard No. 14 discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

[37/] *See* paragraph 10 of Auditing Standard No. 14, which requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.

[38/] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k) and Rule 2-07(a)(3) of Regulation S-X, 17 C.F.R. § 210.2-07 (a)(3).

Departure from the Auditor's Standard Report

21. The auditor should communicate to the audit committee the following matters related to the auditor's report:

a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and

b. When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.

Disagreements with Management

22. The auditor should communicate to the audit committee any 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. Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

Difficulties Encountered in Performing the Audit

23. The auditor should communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

a. Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;

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

c. Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;

d. Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and

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

> Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39/] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

Other Matters

24. The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.[40/]

Form and Documentation of Communications

25. The auditor should communicate to the audit committee the matters in this standard, either orally or in writing,[41/] unless otherwise specified in this standard. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.[42/]

> Note: If, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs 12 or 18 and, as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor must include a copy of or a summary of management's communications

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

40/ AU secs. 316.79-.81 and AU sec. 317.17 include specific communication requirements relating to fraud or illegal acts, respectively.

41/ *See* paragraphs .07-.11 of AU sec. 532, *Restricting the Use of an Auditor's Report,* which apply to certain written reports on matters coming to the auditor's attention during the course of the audit.

42/ Consistent with the requirements of Auditing Standard No. 3, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

provided to the audit committee in the audit documentation.

Timing

26. All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report.[43/] 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, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

> Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit. The auditor, however, should communicate such matters to the audit committee prior to the issuance of the auditor's report.

[43/] Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

APPENDIX 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 the company, the entire board of directors of the company.

For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements 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.