

Heads Up

In This Issue:

- PCAOB Developments
- Auditor Independence and Audit Firm Rotation
- Going Concern
- PCAOB Pricing Sources Task Force
- Improving the Transparency of Audits
- Year-End Audit Risk and Financial Reporting Issues
- Overview of Comments on the Auditor's Reporting Model

A Summary of the November 9–10 Meeting of the PCAOB's Standing Advisory Group

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At the November 9–10, 2011, PCAOB Standing Advisory Group (SAG) meeting, the PCAOB provided an update on recent developments, including an overview of its current and future standard-setting activities. In addition, the PCAOB and SAG discussed the following: auditor independence and audit firm rotation, going concern, fair value pricing sources, improving the transparency of audits, year-end audit risk and financial reporting issues, and public comments on the PCAOB's concept release on the auditor's reporting model.

The next SAG meeting is scheduled for May 16–17, 2012.

PCAOB Developments

PCAOB Chairman James Doty provided an update on several PCAOB developments and policy initiatives that are under way, including the following:

- Inspection-related matters, including the PCAOB's progress on inspections in non-U.S. jurisdictions and the interim inspection program for audits of broker-dealers.
- Recent enforcement matters related to cooperation with the PCAOB and compliance with PCAOB standards.
- The introduction of a PCAOB scholarship program by using funds gained through enforcement mechanisms.
- Continuation of small-business outreach forums and development of an outreach program for auditors of broker-dealers.

In addition, Chief Auditor Marty Baumann provided an update on the PCAOB's progress on various standard-setting activities and reviewed its future standard-setting agenda. On the basis of its updated standard-setting [agenda](#), the PCAOB expects to do the following by June 2012:

- Issue proposed standards on the following topics for public comment:
 - The auditor's reporting model.
 - Audit transparency — identification, in the auditor's report, of the engagement partner and other public accounting firms or persons not employed by the auditor.
 - Situations in which part of the audit is performed by other auditors (principal auditor).
 - Assignment and documentation of firm supervisory responsibilities (failure to supervise).

While several SAG members strongly supported mandatory firm rotation because they view it as a key component to enhancing independence and objectivity, others expressed concerns and believed that it may be more beneficial to investors when auditors have a depth of knowledge based on tenure.

- o Fair value measurement of financial instruments.
- o Specialists.
- o Related parties.
- Repropose, or issue final, standards on the following topics:
 - o Audits of broker and dealers.
 - o Communications with audit committees.
 - o Confirmations.
- Consider staff recommendations on codification of PCAOB standards.
- Hold a roundtable on auditor independence, objectivity, and professional skepticism and consider next steps.

If followed, the above agenda will result in some significant changes to the PCAOB's standards. Some SAG members were concerned about the ambitious nature of the projects for the upcoming year, questioned whether the PCAOB's resources were sufficient to complete the substantial number of projects, and were skeptical about audit firms' ability to absorb and implement many new standards within a short time frame. Other members noted that it was critical to continue to work on all of the topics listed. To avoid overwhelming auditors (and, as a result, issuers and audit committees) with required changes in connection with the performance of audits, PCAOB board member Jay Hanson commented that he will be considering not only the pace of change but also the proposed effective dates.

Auditor Independence and Audit Firm Rotation

The SAG meeting included a discussion of the PCAOB's August 16, 2011, [concept release](#)¹ on auditor independence and audit firm rotation. As noted in the [SAG briefing paper](#), the PCAOB issued the concept release "to solicit public comment on ways that auditor independence, objectivity and professional skepticism can be enhanced, including through mandatory rotation of audit firms. Mandatory audit firm rotation would limit the number of consecutive years for which a registered public accounting firm could serve as the auditor of a public company." While several SAG members strongly supported mandatory firm rotation because they view it as a key component to enhancing independence and objectivity, others expressed concerns and believed that it may be more beneficial to investors when auditors have a depth of knowledge based on tenure. Some members also suggested that firm rotation was not a "silver bullet" that could eliminate complex challenges related to performing high-quality audits and that other less costly measures that focus more directly on enhancing auditors' independence and professional skepticism should be considered.

Editor's Note: For more information about the concept release, see Deloitte's August 26, 2011, [Heads Up](#).

Some SAG members suggested alternatives for the PCAOB to consider in lieu of mandatory firm rotation, including the following:

- Strengthening of the role of the audit committee and board of directors, requiring continuing education of board members to ensure competency, and redefining the term "financial expert."
- Increasing audit transparency.
- Using a lower materiality for performing auditing procedures.
- Using a forensic auditor at specified intervals.

Comments on the concept release were due by December 14, 2011. The PCAOB plans to hold a roundtable in the first quarter of 2012 to gather additional feedback.

¹ PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation — Notice of Roundtable*.

Meeting participants generally agreed that the PCAOB, FASB, and SEC should work together to develop guidance on going concern, including appropriate criteria, management's determinations and disclosures, and subsequent evaluation by auditors.

Going Concern

This discussion was an update to a prior SAG discussion on going concern (held in April 2009) in light of additional comments from the PCAOB's Investor Advisory Group and the FASB's ongoing consideration of new accounting requirements related to going concern. The PCAOB staff noted that its inspection findings related to compliance with current auditing standards on going concern have not been significant.

FASB board member Lawrence Smith gave an update on the FASB's project on risks and uncertainties, including going concern. The FASB issued an initial exposure draft on going concern in 2008, but negative feedback and ongoing research have resulted in multiple changes to the direction of the project since then. Most recently, in November 2011, the FASB discussed whether management should be required to disclose its assessment of the entity's ability to continue as a going concern. Board members could not reach a clear agreement, so they concluded that further research into how to define substantial doubt was warranted.

Professor K. Raghunandan of the American Accounting Association presented some academic research on the topic of going concern, noting that the rate of "bankruptcies without a previous going concern opinion" was increasing. However, many SAG members noted that the current model for evaluating going concern was a liquidity model, not a solvency model (or bankruptcy predictor), and that if a solvency model was the preferred approach, the PCAOB would need to make revisions to its standards because the procedures that auditors would need to perform in such a situation would be much different from those performed today.

Meeting participants generally agreed that the PCAOB, FASB, and SEC should work together to develop guidance on going concern, including appropriate criteria, management's determinations and disclosures, and subsequent evaluation by auditors. The PCAOB has not provided a specific time frame for project milestones but noted that it will continue to monitor the progress of the FASB. The FASB's [technical plan](#) states that the Board hopes to issue an exposure draft on this topic in the first half of 2012.

PCAOB Pricing Sources Task Force

The PCAOB staff gave an update on the work of the PCAOB's pricing sources task force, which consists of several SAG members as well as other investors, preparers, auditors, and representatives from pricing services. Overall, SAG members seemed to agree that issuers and auditors could not simply rely on the values provided by third-party pricing sources. Some comments suggested that it is important for issuers to (1) have appropriate controls in place, (2) have employees who understand the complexity of financial instruments held by the company, (3) visit the third-party pricing sources to understand their process of valuation, and (4) receive SAS 70² reports on the third party's process and controls. Similarly, some SAG members believe that auditors should "get behind the numbers." Members also noted that financial instruments that are valued by collecting multiple traded quotes would have different risks of valuation uncertainty than financial instruments that are valued by using models. The PCAOB is concerned that auditors are not performing consistent procedures regarding information obtained from pricing services and plans to issue proposed amendments to its standards on fair value measurement of financial instruments in the first quarter of 2012.

Improving the Transparency of Audits

Another topic of discussion at the meeting was the PCAOB's October 11, 2011, proposed amendments,³ which are intended to improve audit transparency by requiring disclosure of (1) the engagement partner responsible for the audit and (2) certain other audit participants. Overall, SAG members seemed supportive of identifying the engagement partner in the auditor's report, although many audit firms stated that they did not believe such identification would change the level of care each partner took in ensuring audit quality for any given engagement. Regarding identifying other auditors involved in the

² AICPA Statement on Auditing Standards No. 70, *Service Organizations*.

³ PCAOB Release No. 2011-007, *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2*.

audit engagement, most members seemed to believe that entities should apply a simple, quantitative approach to identification that is consistent with other PCAOB requirements related to audit firm registration with the PCAOB.

Comments on the proposed amendments are due by January 9, 2012. The PCAOB expects to issue a final standard in the third quarter of 2012.

Year-End Audit Risk and Financial Reporting Issues

SAG members noted that many of the conditions highlighted in the PCAOB's Practice Alert 3,⁴ which was issued in 2008, continue to exist and believe that the PCAOB should issue a practice alert to underscore aspects of the newly released risk assessment standards that are particularly important in the current economic environment. Aspects identified by SAG members include:

- Lack of pertinence of historical data to evaluations of items such as impairment calculations, collectibility of sales, and fair value.
- Need for professional skepticism.
- Importance of disclosures about risks and uncertainties.
- Identification of related parties.

The PCAOB has taken into account the feedback from the SAG in developing Staff Audit Practice Alert 9,⁵ which was issued on December 6, 2011.

Overview of Comments on the Auditor's Reporting Model

The PCAOB staff presented a summary of the comments received on its June 21, 2011, concept release⁶ on alternatives for changing the auditor's reporting model. Comments on the concept release were due by September 30, 2011.

The PCAOB's summary broke comments down according to type of commenter (e.g., investors, academics) and indicated that investors strongly supported requiring an auditor's analysis and discussion while audit firms and audit committees did not. Audit firms supported emphasis-of-matter paragraphs and additional attestation engagements. Some SAG members noted that the purpose of the auditor's report is to communicate to investors and that if investors strongly believe that auditors should provide additional disclosures, the PCAOB should adopt standards that require such disclosures.

The PCAOB plans to issue a revised proposal on changes to the auditor's report for public comment in the second quarter of 2012.

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⁴ PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment*.

⁵ PCAOB Staff Audit Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment*.

⁶ PCAOB Release No. 2011-003, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements — and Related Amendments to PCAOB Standards*.

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