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PCAOB Issues Proposed Auditing Standard on Communications With Audit Committees

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On March 29, 2010, the PCAOB issued "Proposed Auditing Standard Related to Communications With Audit Committees," which would supersede PCAOB AU Section 380, "Communications with Audit Committees," and PCAOB AU Section 310, "Appointment of the Independent Auditor." Comments are due by May 28, 2010. Under the proposal, the standard would be effective for fiscal years beginning after December 15, 2010.

The PCAOB's primary objectives in proposing the 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 carries forward substantially all of the communication requirements of the current standards. For certain matters, the proposed standard requires auditors to provide additional communications. In drafting the proposed standard, the Board considered the requirements of the comparable standards of the International Auditing and Assurance Standards Board and the AICPA's Auditing Standards Board. Both standards were revised before the proposal was issued.

The table in the Appendix lists the communications required by the proposed standard, as well as by other PCAOB standards and rules, and identifies those that are new or expanded.

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Themes of Changes

The PCAOB has sought to improve audit committee communications by expanding upon existing communication required in critical areas such as estimates, disclosures, and significant risks. The proposal also mentions the importance of communications about complaints or concerns expressed about audit or accounting matters. Auditors are already carrying out many of the new or expanded requirements today, but they are not necessarily consistently doing so across the profession.

We encourage audit committees to study the proposal and to submit comments to the PCAOB. Audit committees and auditors should give careful consideration to whether and how the requirements in the proposal will improve communication and, thereby, audit committee performance. Some of the proposed requirements, such as communicating consultations on significant accounting matters, may be helpful in some circumstances but may contribute to information overload in others. Some questions to consider include:

- Whether the proposed required communications are useful to the audit committee. What should be added, deleted, or made optional?
- How to improve the two-way dialogue between the audit committee and the auditor. Are there aspects of the proposed standard that will improve two-way communications? Are there aspects that will hinder two-way communications?
- Is management prepared to address the communications about accounting policies, estimates, and judgments? Usually it is best for management to do so and then for the auditor to comment on management's presentation.

Overview of the Proposed Standard and Changes From the Existing Standards

The proposed standard states that 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.

The proposal outlines requirements (discussed below), to fulfill these objectives, many of which are present in the current standards.

Significant Issues Discussed With Management in Connection With Appointment or Retention

The proposed standard reiterates the existing requirement to communicate to the audit committee any significant issues discussed with management in connection with initial appointment or retention. The release that accompanies the proposed standard adds that retention does not limit the matters communicated to those that were discussed just before retention but rather could include discussions that took place throughout the auditor's relationship with the company.

Establish a Mutual Understanding of the Terms of the Audit

Under the proposal, the auditor should establish annually a mutual understanding of the terms of the engagement with the audit committee. The auditor would achieve this by providing a written engagement letter to the audit committee each year that, among other things, describes the objective of an audit, the auditor's responsibilities, and the responsibilities of management. Because the current standards were written before the Sarbanes Oxley Act, they do not specifically require that understanding be reached with the audit committee, nor do they require documentation of the terms in an annual engagement letter. However, auditors commonly perform such practices.

Under the proposal, the auditor should establish annually a mutual understanding of the terms of the engagement with the audit committee.

Obtaining Information Related to the Audit

The proposal requires the auditor to ask the audit committee whether it is aware of matters relevant to the audit that the auditor should also be aware of, including complaints or concerns raised about accounting or auditing matters.

Overview of the Audit Strategy and Timing of the Audit

Under the proposal, the auditor should give the audit committee an overview of the audit strategy, including the significant risks and the timing of the audit. In addition, the proposal requires the auditor to timely communicate significant audit strategy changes or changes to the significant risks. The communication of the audit strategy should include (1) the determination of whether specialists are needed on the audit; (2) the consideration and planned use by the auditor of the work of internal auditors and similar persons; (3) the roles, responsibilities, and locations of the firms participating in the audit (those in and out of the network to which the principal auditor belongs); and (4) the basis for the auditor's determination that he or she can serve as the principal auditor.

Accounting Policies, Practices, and Estimates

The proposed standard carries forward the existing requirement for the auditor to discuss with the audit committee the auditor's judgments about the quality, and not just the acceptability, of the company's accounting principles. In doing so, the auditor considers whether all appropriate disclosures are made and whether the disclosures facilitate an investor's understanding of the financial statements.

In addition, a new requirement is proposed for the auditor to communicate, or determine that management has communicated, the anticipated application of new accounting or regulatory pronouncements that are not yet effective but that may, upon adoption, significantly affect the company's financial reporting.

The proposed standard includes requirements that are consistent with those in Rule 2-07 of Regulation S-X stating that the auditor should communicate critical accounting policies directly to the audit committee as well as communicate alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items discussed with management.

Under the proposal, the auditor should give the audit committee an overview of the audit strategy, including the significant risks and the timing of the audit.

The proposal outlines a new requirement for auditors to communicate consultations that the engagement team has had with others outside the engagement team concerning significant accounting matters (other than those with the engagement quality reviewer) to inform the audit committee about complex, high risk, or controversial transactions.

To help focus the communications about accounting estimates on those that are subject to higher risks of material misstatement, the proposed standard aligns the definition of "critical accounting estimate" with that used by the SEC: an "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."

New requirements in the proposal related to estimates state that auditors should communicate (or evaluate whether management has adequately communicated) (1) how management subsequently monitors critical accounting estimates; (2) management's significant assumptions used in critical accounting estimates that have a high degree of uncertainty; (3) significant changes in assumptions or processes made by management, the reasons for the changes, the effects on the financial statements, and information that supports or challenges such changes; and (4) how recorded estimates relate to their reasonable range and how various selections within the range would affect the financial statements.

The auditor should also communicate his or her evaluation of the reasonableness of the process used by management to develop critical accounting estimates and the basis for conclusions about the reasonableness of the estimates. If the auditor determines that management's estimates are potentially biased, the auditor should communicate this to the audit committee.

Management Consultations With Other Accountants

The proposal carries forward the current requirement to communicate management's consultations with other accountants about auditing or accounting matters, including the auditor's views about such matters.

Going Concern

Although auditors typically communicate going-concern matters to the audit committee, currently there is no specific requirement for them to do so. The proposed standard requires that when the auditor has determined that possible substantial doubt about whether a company is a going concern has been mitigated by management's plans, the auditor should communicate (1) the reasons why substantial doubt could exist and (2) the reasons why such doubt has been mitigated. If substantial doubt was not mitigated, then the auditor is required to communicate his or her assessment of management's plans, the effect on the financial statements, including the disclosures, and the effect on the auditor's report.

Corrected and Uncorrected Misstatements

The proposed standard reiterates the existing requirements to communicate corrected and uncorrected misstatements. It also emphasizes that auditors should include misstatements related to disclosures when communicating misstatements.

Other Matters

Under a new requirement in the proposal, the auditor should communicate matters arising from the audit that are significant to the oversight of the financial reporting process, including situations in which the auditor is aware of concerns having been raised about auditing or accounting matters.

Although auditors typically communicate going-concern matters to the audit committee, currently there is no specific requirement for them to do so.

Form and Content

The proposed standard continues to allow both written and oral communication. However, when communication is oral the auditor is specifically required to document the communication such that an experienced auditor with no previous connection with the engagement can understand the communication made. The existing standard requires any written communication to be restricted to the use of the audit committee, board of directors, or management. The proposed standard does not contain this requirement, although auditors may restrict reports if they wish to.

Timing

Currently, communications with audit committees are not required to occur before the issuance of the auditor's report, although they often take place before such issuance. The PCAOB's proposing release explains that the communications are considered to be an integral part of the audit and not incidental to the process. The proposed standard, therefore, specifically requires the communications to be completed before issuance of the auditor's report, and, because the significance of specific matters may change from year to year, it also requires annual communication of recurring matters.

Other Communication Requirements

The proposed standard also includes communication requirements, largely taken from the existing standards, that address the auditor's responsibility in connection with information in documents containing audited financial statements, disagreements with management, and difficulties encountered in performing the audit.

The proposal also requires the auditor to inform the audit committee if the auditor expects to modify an opinion or add an explanatory paragraph. This communication requirement includes the modification or an explanatory paragraph and the reasons for them.

Adequacy of Two-Way Communications

To underscore the importance of dialogue between the audit committee and the auditor, the proposal requires the auditor to evaluate whether the communications between the audit committee and the auditor have been sufficiently adequate to support the objective of the audit. If not, the auditor is required to discuss the matter with the board of directors or resign from the engagement.

Appendix

The table below lists the communications required by the proposed standard, as well as by other PCAOB standards and rules, and identifies those that are new or expanded.

Communications Required by the Proposed Standard	New or Expanded Requirement
Significant issues discussed with management before the auditor's appointment or retention.	
Establish a mutual understanding of the terms of the audit.	Expanded
Overview of the audit strategy and timing of the audit.	New
Accounting policies, practices, and estimates.	Expanded
Auditor's evaluation of the quality of the company's financial reporting.	Expanded
Other information in documents containing audited financial statements.	
Management consultations with other accountants.	
Going concern.	New
Corrected and uncorrected misstatements.	
Departure from the standard auditor's report.	New
Disagreements with management.	
Difficulties encountered in performing the audit.	
Other matters.	New
Communications Required by Other PCAOB Standards or Rules	
Material weaknesses and significant deficiencies in internal control.	
Representations of management.	
Fraud and illegal acts.	
Communications in connection with interim reviews.	
Preapproval of services.	
Independence matters.	

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