

## Heads Up

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## A Summary of the October 13–14 Meeting of the PCAOB’s Standing Advisory Group

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At its October 13–14, 2010, meeting, the PCAOB’s Standing Advisory Group (SAG) discussed the following: designing and implementing a firm system of quality control, FASB projects and their potential impact on auditors, and potential PCAOB rulemaking regarding the failure to supervise. In addition, the PCAOB provided an update on recent PCAOB developments and on its standard-setting activities.

The next SAG meeting is scheduled for March 23–24, 2011.

### Firm System of Quality Control

The PCAOB currently has on its standard-setting agenda a project to reconsider the quality-control standards for registered public accounting firms. During the meeting, the PCAOB sought the SAG’s views on the design and application of quality-control standards within registered public accounting firms. The [briefing paper](#) on this topic cites the following questions (reprinted in their entirety), which were discussed at the meeting:

1. Could an integrated framework better emphasize the need to design and implement a system of quality control that: (1) appropriately develops all necessary elements, (2) integrates those elements of quality control into a complete system, and (3) stresses an ongoing assessment and remediation of deficiencies?
2. Would a separate risk assessment process to identify, assess, and address relevant risks to audit quality improve the design and implementation of systems of quality control?
3. What changes to the Board’s quality control standards would better motivate firms to use known audit deficiencies to identify and remediate the defects in quality control that allowed the deficiencies to occur?
4. Are there lessons learned from other industries that could be useful in designing and implementing systems of quality control for accounting firms? For example, recent reforms instituted for credit rating agencies?
5. What changes to the Board’s quality control standards might be necessary in light of the potential challenges to designing and implementing a system of quality control? Are there other challenges that should be considered?
6. What attributes are necessary for a firm culture to be conducive to audit quality? What requirements or other measures could the PCAOB propose to motivate firms to promote a firm culture that minimizes incentives that do not promote audit quality?
7. What quality controls should be in place when using the work of a foreign affiliated firm?

SAG members urged the PCAOB to update its quality-control standards, emphasizing “tone at the top” and the personnel assigned to quality-control roles. One SAG member suggested that the PCAOB issue best practices for systems of quality control that were identified during the inspection process.

**Editor’s Note:** The International Auditing and Assurance Standards Board and the AICPA’s Auditing Standards Board have updated their quality-control standards by issuing International Standard on Quality Control No. 1, *Quality Control for Firms That Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and Statement on Quality Control Standards No. 7, *A Firm’s System of Quality Control*, respectively.

## FASB Projects and Potential Impact on Auditors

This session of the SAG meeting was a follow-up discussion from the July 15, 2010, SAG meeting. (For more information, see Deloitte’s [August 31, 2010, Heads Up](#).) At the prior meeting, SAG members suggested that potential audit issues be discussed at the same time as the FASB comment letter review process. Therefore, at the current meeting, the SAG discussed recently proposed FASB accounting standards and related auditing issues. The following topics (reprinted from the PCAOB’s [briefing paper](#)) were addressed:

- Potential challenges to auditing under the new accounting standards given the possibility for greater diversity by preparers in reporting transactions with similar facts and circumstances (e.g., preparers and auditors may interpret the terms “substantially the same” or “reasonably effective” differently resulting in diversity in practice).
- The possible need for new or revised PCAOB auditing standards or additional audit guidance because of the significant increase in the use of fair values, estimates and judgments by preparers (e.g., some have suggested the need for separate auditing guidance in response to the proposed changes in accounting for revenue).
- Potential auditing challenges an auditor would face in determining whether a company’s disclosures meet the requirements of the proposed accounting standards and sufficiently describe the information essential for fair presentation of the financial statements (e.g., under the new disclosure framework, when does a disagreement over the extent of disclosure rise to a level of an audit difference?).
- Potential auditing challenges an auditor would face in evaluating information included in the measurement uncertainty analysis. Do other “amounts that could have been reasonably used in the circumstances” indicate a bias in estimates or an audit difference (e.g., what if a majority of amounts disclosed are less than those estimates used in preparing the financial statements?).
- Potential challenges for auditors in obtaining the audit evidence necessary to evaluate the proposed disclosure (or the lack of disclosures) of certain asserted remote loss contingencies that potentially may have a severe impact on the company (e.g., . . . the [American Bar Association Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information] does not address the disclosure of certain asserted remote loss contingencies. The PCAOB has no jurisdiction over attorneys’ professional requirements. As such, are there other sources of evidence an auditor could obtain regarding remote loss contingencies?

There was considerable debate and discussion regarding the increase in judgment that will be expected of both issuers and auditors as a result of the more principles-based approach the FASB is taking in the accounting standards. The discussion included the following observations:

- Increased judgment results in a need for increased documentation to support those judgments. Some suggested that the SEC should explicitly require such documentation by issuers.
- Some suggested that issuers need a judgment framework to help them make accounting decisions. Others believed that a similar judgment framework should also be developed for auditors, although there was some disagreement on this point.
- Some cautioned that, rather than be indirectly contained in PCAOB standards, guidance for issuers should be developed and released by the SEC.
- Board member Charlie Niemeier raised concerns about what appears to be a trend of relying on increased disclosures to offset measurement uncertainty, even though disclosures are subjective and difficult to audit.

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- One member wanted to emphasize the importance of professional skepticism on the part of auditors.

## Failure to Supervise

The PCAOB staff discussed its recent concept release *Application of the "Failure to Supervise" Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment On Rulemaking Concepts*. Section 105(c)(6) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") authorizes the Board to impose sanctions on registered public accounting firms and their supervisory personnel for failing "to reasonably supervise an associated person" who has violated certain laws, rules, or standards. The concept release seeks comment on potential rulemaking related to the application of Section 105(c)(6), including potentially requiring firms to document assignments of supervision responsibilities throughout the firm.

SAG members indicated that there should be clear responsibility for complying with quality-control standards. There was some discussion regarding the meaning of "supervision" and how that term would apply to situations outside those involving engagement teams. Many SAG members commented that (1) guidance on this matter should be flexible enough to allow audit firms of various sizes to comply and (2) requirements and guidance should be incorporated into the quality-control standards.

## PCAOB Developments

### Recent Activities

Acting PCAOB Chairman Dan Goelzer gave an overview of some of the Board's recent activities, including the following:

- The PCAOB has asked Congress to amend the Sarbanes-Oxley Act to make the Board's disciplinary proceedings public. The amendment, if passed, would make the proceedings public at the point the Board has determined to pursue an investigation (though they would remain nonpublic during the information-gathering phase). The Sarbanes-Oxley Act currently requires that these proceedings be nonpublic unless the Board finds good cause to make them public and all parties consent to do so.
- On October 7, the PCAOB issued a [news release](#) announcing that effective for all pending and future registration applications from accounting firms in non-U.S. jurisdictions, an applicant will be asked to indicate, to the best of its knowledge, whether local law or authorities would currently allow the PCAOB to inspect its firm. If such an applicant, "in order to obtain earlier action on its application, responds that PCAOB inspection would not currently be allowed, the Board will issue a Notice of Hearing to consider whether, in light of the obstacle to inspection, approval of the application would be consistent with the Board's responsibility under the Sarbanes-Oxley Act of 2002."
- The PCAOB is currently considering how to implement the new authority granted to it by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (i.e., the authority to oversee audits of nonpublic broker-dealers). Issues the Board is deliberating include how accounting support fees to fund this oversight will be charged to broker-dealers, how the inspection program will be implemented, and what auditing standards are needed on this topic.
- The PCAOB continues to consider the [recommendations](#) from the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession. Some recommendations have been, or are currently being, implemented (the PCAOB has hired its first academic fellow and is starting a fraud center). Other recommendations need further analysis and study (e.g., the recommendation regarding potential changes to the auditor's report).
- On September 29, 2010, the PCAOB issued its *Report on Observations of*

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*PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis.* The [report](#) discusses inspectors' observations of audit risks resulting from the economic crisis, specifically of:

- o Audits of issuers in the financial services industry for fiscal years 2006–2008.
- o Audits of issuers in nonfinancial services industries for fiscal year 2008, "when the economic crisis affected a broader range of business sectors."

### Standard-Setting Activities

Chief Auditor Marty Baumann and the PCAOB staff provided an update on various standard-setting activities, including the following:

- The upcoming [standard-setting agenda](#).
- An overview of the key provisions of the PCAOB's newly approved standards *Auditing Standards Related to the Auditor's Assessment of and Response to Risk*. These eight new standards address audit risk, audit planning, supervision of the audit engagement, materiality, identifying and assessing risks of material misstatement, the auditor's responses to risk, evaluating audit results, and audit evidence. The new standards are intended to provide the framework for the audit process going forward. Pending SEC approval, these standards will be effective for audits of periods beginning on or after December 15, 2010. The [presentation](#) on this topic at the meeting is available on the PCAOB's Web site.
- The PCAOB staff shared with the SAG some of the feedback the Board has received on its proposed confirmations standard. The PCAOB received support for proposing a new standard and updating the guidance for advances in technology that have taken place since the original standard was promulgated. Several commenters were concerned about the number of requirements in the standard and suggested the development of a more risk-based approach. Some SAG members noted that the standard should allow for the use of internal audit in the confirmation process, but the PCAOB staff strongly believed that the involvement of internal audit would compromise the auditor's control over confirmations.

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