

Heads Up

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A Summary of the March 24 Meeting of the PCAOB's Standing Advisory Group

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At the March 24, 2011, PCAOB Standing Advisory Group (SAG) meeting, the PCAOB provided an update on recent developments and on its standard-setting activities. In addition, the PCAOB and the SAG discussed the following: FASB projects, related effective dates and transition methods, and their potential impact on audits; the project undertaken by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to modernize its internal control framework; auditing financial statement disclosures; and potential changes to the auditor's reporting model.

The next SAG meeting is scheduled for June 29, 2011.

PCAOB Developments

This was the first SAG meeting attended by James Doty, the PCAOB's new chairman. Chairman Doty took this opportunity to offer his views on the PCAOB's ongoing activities, including the following:

- *Transparency and outreach* — Chairman Doty commented on the Board's commitment to transparency and outreach. He pointed to two recent meetings as important examples of this commitment. The first was the PCAOB's March 22 open meeting, at which the Office of the Chief Auditor presented the results of its outreach to investors and others on potential changes to the auditor's report (see further discussion below). Mr. Doty explained that such outreach and such a meeting (before exposure of a document) were unprecedented for the PCAOB. The second meeting Mr. Doty referred to was the Investor Advisory Group's (IAG's) March 16 meeting, during which the Board heard views of three IAG working groups regarding (1) lessons learned from the economic crisis, (2) global network firms and governance, and (3) the auditor's reporting model. Webcasts of the [open board meeting](#) and the [IAG meeting](#) and related materials are available on the PCAOB's Web site.
- *Inspections* — Chairman Doty discussed the recent appointment of [Helen Munter](#) as the director of the Division of Registration and Inspections. He explained that (1) it is a critical time in inspections; (2) through the inspection process, the Division continues to find issues related to the financial crisis, valuation, use of substantive analytics, reliance on business processes, entity-level controls, and other topics; and (3) the Division is focusing on achieving consistency in how deficiencies are identified and characterized. Mr. Doty also noted that the Division is focusing on discovering the root causes of the inspection issues identified and on finding ways of addressing the root causes and improving audits going forward.

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- *International matters* — Chairman Doty explained that one of the PCAOB's highest priorities is to reach cooperative agreements to facilitate inspections in jurisdictions in which the Board has been unable to perform inspections. He referred to the recent agreement reached with the United Kingdom and mentioned that the Board believes that the format of the U.K. agreement may be a model for future agreements. He also stated that as a result of the PCAOB's new ability under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") to share inspection results with non-U.S. counterpart regulators (subject to confidentiality rules), the PCAOB hopes to soon make several announcements about inspection arrangements in additional jurisdictions.

Editor's Note: On April 4, 2011, Chairman Doty also announced that the PCAOB concluded an agreement to conduct joint inspections with Swiss authorities.

- *Enforcement* — Chairman Doty commented that, while the PCAOB has asked Congress to amend the Sarbanes-Oxley Act of 2002 so that its disciplinary proceedings can be made public, the PCAOB should not necessarily wait for Congress to act before taking additional action on its own to make the enforcement process more transparent. He explained that the Board is looking carefully at means that might be available through current rules to do so.
- *New authority over broker-dealer audits* — The PCAOB is currently considering how to implement its new authority (granted it by the Dodd-Frank Act) to oversee audits of nonpublic broker-dealers. Chairman Doty explained that this new authority will have a significant impact on the work of the Board and its staff. Further, he noted that the Board is considering comments on its proposed rule on establishing an interim inspection program for broker-dealer audits. He reminded meeting participants that part of the purpose of this proposed rule is for the PCAOB to form judgments regarding whether to use its exemptive authority to potentially exclude from inspections audits of certain broker-dealers, including those considered "introducing broker-dealers."
- *Continuing issues related to the economic crisis* — Chairman Doty mentioned that the PCAOB continues to consider issues related to the recent economic crisis and cited the Board's September 2010 *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* as an example of this. In particular, he pointed out that the Board has begun to think about the best way to investigate and analyze the possible audit issues behind the crisis.

Standard-Setting Activities

Chief Auditor Marty Baumann gave an update on the PCAOB's various standard-setting activities, including the following:

- The addition of two new projects to the Board's standard-setting agenda: (1) codification of PCAOB standards and (2) a proposal requiring disclosure of other auditors involved in the performance of an audit and the extent of this involvement.
- The acceleration of standard-setting timelines associated with two projects: (1) standards for audits of broker-dealers and (2) revisions to the auditor's reporting model.

Mr. Baumann pointed out that, in general, the timelines in the Board's [October 2010 agenda](#) would be extended one quarter on all projects (with the exception of the auditor's reporting model, for which a concept release is expected to be released by June 30, 2011, as discussed below).

Some SAG members cautioned that careful thought should be put into the transition to new standards so that issuers and auditors have adequate time to prepare.

FASB Projects and Potential Impact on Audits

This session of the SAG meeting was a follow-up discussion from the July 2010 and October 2010 SAG meetings. (For more information, see Deloitte's August 31, 2010, [Heads Up](#) and October 22, 2010, [Heads Up](#), respectively.) At prior SAG meetings, there was considerable debate regarding the increased judgment that will be required of both issuers and auditors as a result of the current trend of more principles-based accounting standards. The SAG has also suggested that potential audit issues be discussed at the same time as the FASB comment letter review process.

At the current meeting, FASB board member Larry Smith gave an update on the FASB's standard-setting agenda. After his [presentation](#), several questions were raised regarding various aspects of the accounting standards the FASB is working on. There was also considerable discussion regarding effective dates and the pace of change for accounting standards. Some SAG members cautioned that careful thought should be put into the transition to new standards so that issuers and auditors have adequate time to prepare. These comments were in response to questions raised in the PCAOB's [briefing paper](#).

Modernization of COSO Framework

COSO Chairman David Landsittel gave an overview of the project the organization has recently undertaken to update its *Internal Control — Integrated Framework*, originally published in 1992. COSO has hired PricewaterhouseCoopers to manage the project, gather input, prepare and draft the public exposure document, and collect and review public comments. In addition, COSO has created an advisory council to provide input on the project and review draft deliverables. The SEC and PCAOB are also participating in the project as observers. For more information, see the [briefing paper](#) and [slides](#) used in the presentation.

To help plan the project, COSO launched a survey seeking input on which aspects of the framework should be updated. So far, COSO has received more than 700 responses to the survey from a wide variety of organizations and individuals. Overall, most respondents believe that the framework should be updated but do not support a major overhaul. In line with this feedback, COSO does not intend to alter the original framework's five core components (risk assessment, control environment, control activities, information and communication, and monitoring). However, COSO explained that changes may be made to the application of those components.

Several SAG members asked questions about the COSO project and gave their input on possible issues to consider, including the following:

- How internal control relates to enterprise risk management.
- How to describe "tone at the top."
- The definition of a "financial expert."
- What constitutes effective internal control.

During this discussion, COSO explained that its 2006 guidance *Internal Control over Financial Reporting — Guidance for Smaller Public Companies* would be integrated with the updated framework and superseded.

COSO is expected to expose the draft of its updated framework for public comment between September and December 2011.

Auditing Financial Statement Disclosures

The PCAOB sought input on whether the auditor's responsibilities for auditing financial statement disclosures should be updated or enhanced. The discussion included whether the PCAOB should make revisions to existing auditing standards or provide additional guidance. Specifically, the PCAOB staff sought feedback from the SAG on the following questions (reprinted from the PCAOB's [briefing paper](#)):

1. What are the challenges in auditing financial statement disclosures? Have recent changes to the accounting standards resulted in auditing challenges?

2. Are changes to auditing standards needed regarding auditing financial statement disclosures?

SAG members acknowledged the general trend in accounting standards to require additional disclosures. Their concerns regarding this trend included the following:

- Increasing the number of disclosures and lengthening Forms 10-K does not necessarily improve the understandability of the financial statements. One SAG member therefore suggested a more holistic approach to assessing current disclosures and creating an overall disclosure framework.
- More and more disclosures are based on subjective information that is difficult to audit. One SAG member questioned whether auditors are properly prepared and equipped to audit footnotes that contain forward-looking information.
- When disclosures are omitted or are inadequate, auditors may find it challenging to determine whether the financial statements are materially misstated as a result. One SAG member suggested the potential need for a materiality threshold for disclosures.

Several SAG members also referred to the [discussion paper](#) issued by the International Auditing and Assurance Standards Board in January 2011 (on which comments are due by June 1, 2011). The purpose of that discussion paper is to obtain input from preparers, investors, lenders, regulators, and auditors on challenges in creating, auditing, and interpreting the assurance auditors provide on disclosures. It was recommended that the PCAOB consider the feedback received on the discussion paper as part of its own project.

Auditor's Reporting Model

The PCAOB staff gave an update on its project on the auditor's reporting model. Over the past several months, the PCAOB has interviewed various stakeholders regarding potential changes to the auditor's report. At the current meeting, the PCAOB staff gave an overview of the input it received from these interviews (the same overview that was presented to the Board at its March 22, 2011, open meeting).

The following is a summary of investors' recommended changes to the auditor's reporting model:

- More explanation of what the auditor did to perform the audit (including a discussion of risks, responses to those risks, and materiality).
- A description of the auditor's views on specific aspects of the financial statements (including management estimates, accounting policies, and contentious and difficult issues).
- Clarification of the standard language in the auditor's report (e.g., the auditor's responsibility for detecting fraud and the meaning of reasonable assurance).
- Increased responsibility for information outside the financial statements (e.g., MD&A, earnings releases).
- Providing investors with the same information the auditor provides to the audit committee.

However, the views preparers and audit committees expressed in their feedback were quite different from those of investors. In general, preparers:

- Disagree with the investors' belief that auditors should provide more information or views regarding the company's financial statements. Preparers are concerned that the responsibilities of management and the auditor could become obscured, potentially resulting in conflicting disclosures. They are also concerned about the potential costs of some of the investors' suggestions.
- Were comfortable with auditors providing more information about the audit and procedures performed.
- Supported the inclusion of clarifying language in the auditor's report regarding fraud, reasonable assurance, and what an audit does and does not achieve.

Investors' recommended changes to the auditor's reporting model included more explanation of what the auditor did to perform the audit.

Audit committee members' concerns were similar to those of preparers. In addition, they believed that (1) some of the changes suggested by investors could undermine the role of the audit committee and (2) if auditors are required to provide investors with the same information provided to the audit committee, investors may not understand the context and communications between audit committees and auditors might become stifled and less effective.

Lastly, auditors expressed their views. In general, auditors:

- Supported the following potential changes:
 - Providing additional information regarding the scope of the audit and procedures performed.
 - Additional auditor association with MD&A.
 - If the audit committee report is expanded, providing additional assurance regarding that report.
- Do not want to be the original source of information regarding the financial statements, believing that this will obscure the auditor's role.
- Were concerned about potential client confidentiality issues, potential negative impacts on the effectiveness of communication between auditors and the audit committee, the time and effort it would take to provide a longer report, and the ability to provide additional reporting under the current SEC filing deadlines.

On the basis of the input it received, the PCAOB is considering requiring the following:

- An "auditor discussion and analysis" (along with the auditor's report) that would include information on matters such as significant audit risks, audit responses to those risks, materiality, auditor independence, and views regarding certain aspects of the company's financial statements.
- Use of an emphasis-of-matter paragraph in certain additional circumstances.
- A paragraph in the auditor's report that explains the critical decisions made during the audit, with references to the footnotes in which such issues are discussed (this would be similar to the current auditor's reporting model followed in France).
- Further auditor association with, or assurance of, MD&A.
- Auditor association with an expanded audit committee report.

After the discussion, the PCAOB outlined the following next steps for this project:

- Issue for public comment, on or about June 30, 2011, a concept release on potential changes to the auditor's report.
- Hold a roundtable on the concept release sometime in the fall of 2011.
- Issue a proposed standard in the first quarter of 2012.

The PCAOB plans to issue for public comment, on or about June 30, 2011, a concept release on potential changes to the auditor's report.

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