

Heads Up

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A Summary of the November 20–21 Meeting of the PCAOB's Standing Advisory Group

by Jennifer Burns, Deloitte LLP; and Ana Zelic, Deloitte & Touche LLP

Introduction

At the November 20–21, 2014, PCAOB Standing Advisory Group (SAG) meeting, the PCAOB gave an update on recent developments, including an overview of its current and future standard-setting activities. In addition, the PCAOB and SAG discussed:

- Fraud detection, including auditor incentives to detect fraud, behavior-related considerations, lessons learned from other disciplines, and auditors' knowledge and skills regarding fraud detection.
- The new revenue recognition accounting standard¹ and related audit considerations.
- The PCAOB staff's summary of comments received on its Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*.

Recent PCAOB Developments

Chairman James Doty summarized the following recent PCAOB activities:

- *Inspections:*
 - The PCAOB staff is conducting its 2014 inspection cycle. In particular, the staff is focusing on (1) the auditor's identification and assessment of the risk of material misstatements in accordance with PCAOB standards; (2) the implementation of [PCAOB Auditing Standard No. 16, Communications With Audit Committees](#); and (3) root cause analysis of inspection deficiencies.
 - The PCAOB is continuing its efforts to develop cross-border arrangements to facilitate its inspections outside the United States. The PCAOB oversees 230 non-U.S.-based audit firms in 50 foreign jurisdictions that issue audit reports on U.S. issuers, and it has performed inspections in 44 of those jurisdictions. The PCAOB now has [cooperative arrangements](#) to inspect audits in many countries, including most European countries. While it does not have such arrangements in Italy, Belgium, Luxemburg, and Poland, among a few others, it is actively pursuing them. In addition, the PCAOB is continuing to work closely with authorities in China to reach a cooperative arrangement.

¹ For more information about the new revenue standard, see Deloitte's May, 28, 2014, [Heads Up](#) newsletter.

- o The PCAOB is also continuing its interim program to inspect audits of brokers and dealers. In 2014, the PCAOB inspected portions of 100 audits performed by 60 audit firms. Its findings were related to audit procedures associated with (1) computation of customer reserves and net capital, (2) testing of revenue recognition, (3) testing of related-party transactions, and (4) identification of the risk of material misstatements due to fraud. Further, inspection reports continue to include findings related to the independence of audit firms (e.g., when auditors also provided bookkeeping services to a broker-dealer). See the PCAOB’s [report](#) on its interim broker-dealer inspection program for more information.
- *Eighth annual International Auditor Regulatory Institute* — In November 2014, the PCAOB hosted this annual forum, which included more than 60 officials from 30 non-U.S. regulatory agencies. Among the topics discussed was the use of the audit as a means of combatting global corruption, which remains a highly relevant issue.
- *Communications with audit committees* — The PCAOB is exploring ways to communicate preliminary inspection findings and trends to audit committees before issuing its standard inspection reports (e.g., in December or January each year) to help audit committees conduct discussions with auditors about the scope and nature of the procedures that will be performed in connection with the upcoming audit.

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Standard-Setting Agenda

Martin Baumann, chief auditor and director of professional standards, provided an update on the PCAOB’s standard-setting activities outlined in the following table:

Project/Standard	Recent Board Actions
<i>Auditing Accounting Estimates and Fair Value Measurements</i>	Staff Consultation Paper issued in August 2014. The comment period closed in November 2014. (See Auditing Accounting Estimates and Fair Value Measurements below for more information.)
<i>Related Parties</i>	Auditing Standard 18 and related amendments approved by the SEC in October 2014. Effective for fiscal years beginning on or after December 15, 2014, and interim periods within those fiscal years.
Project	Action Expected by March 2015
<i>Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits</i>	Supplemental request for public comment to be issued.
<i>Auditor’s Reporting Model</i>	Reproposal.
<i>Supervision of Other Auditors and Multi-Location Audit Engagements</i>	Proposal.
<i>Use of Specialists</i>	Staff Consultation Paper.
<i>Framework for Reorganization of PCAOB Auditing Standards</i>	Adoption.
<i>Going Concern</i>	Staff Consultation Paper.
Other Active Projects (No Timetable)	
<i>Confirmation</i>	Reproposal.
<i>Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities</i>	Staff Consultation Paper.
<i>Subsequent Events</i>	Proposal.

Staff Practice Alerts and Guidance Recently Issued

Staff Guidance for Auditors of SEC-Registered Brokers and Dealers Issued in June 2014.

Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements* Issued in September 2014.

Staff Audit Practice Alert No. 13, *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* Issued in September 2014.

Editor's Note: One of the PCAOB's most significant near-term projects is the auditor's reporting model. In August 2013, the PCAOB issued a release proposing two new auditing standards — one on the auditor's reporting model and one on the auditor's responsibilities for other information included in annual reports filed with the SEC. In April 2014, the Board held a public meeting to obtain further input on the release (for more information, see Deloitte's [April 30, 2014](#), and [September 5, 2013](#), *Heads Up* newsletters). The comment period ended in May 2014, and the staff is currently analyzing comments received on the release as well as drafting a reproposal that is expected to be issued for public comment in the first quarter of 2015.

In addition, the PCAOB's Office of Research and Analysis is continuing to work on a project to develop a portfolio of audit quality indicators that may provide information and insight into audit quality. The PCAOB is expected to issue a concept release on this topic sometime in the near future.

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The Auditor's Approach to Detecting Financial Statement Fraud

Keith Wilson, deputy chief auditor in the PCAOB's Office of the Chief Auditor, and Mike Gurbutt, senior advisor to the program leader in the PCAOB's Center for Economic Analysis, led panel discussions on topics related to fraud. They noted that the PCAOB staff is conducting outreach — and analyzing available evidence, research, and data — about the auditor's approach to detecting material misstatements of financial statements as a result of fraud. The objective of the PCAOB's outreach is to explore ways to improve audit effectiveness related to detecting financial statement fraud. Panelists focused on (1) the effect of attitudes and behaviors on fraud detection; (2) approaches and methods used in other disciplines that financial statement auditors might apply to detect fraud; and (3) the knowledge and skills needed for effective fraud detection. After each panelist's presentation, SAG members asked questions and provided their own observations. Key themes of the discussions included:

- The importance of the auditor's maintenance of professional skepticism and how to address the auditor's cognitive biases (e.g., "selective attention" or the tendency to see what one expects to see).
- Understanding management's integrity, existing incentives, and opportunities as well as the tone at the top (and throughout an organization) about commitment to ethical values.
- Recommendations that the PCAOB specifically define the types of fraud that are most concerning (e.g., material financial statement misstatements due to fraud rather than immaterial loss of assets due to unethical behavior of an employee).
- The need for an improved learning curriculum for auditors that focuses on assessment and identification of fraud (e.g., training in critical thinking, fraud risk interviews, and brainstorming).
- The use of data analytics and data mining to potentially help in the detection of fraud.

- How to effectively use internal auditors to help in the detection of fraud.
- The need for financial executives, audit committees, internal auditors, and external auditors to work together to develop ways to further enhance the ability to prevent and detect fraud.

Editor’s Note: The topic of fraud is not currently on the PCAOB’s standard-setting agenda. However, given the recent discussions and comments by the PCAOB staff related to fraud, it is possible the PCAOB may consider some action in this area (e.g., a discussion paper).

Revenue Recognition and Auditing Revenue

Associate Chief Auditor Lillian Ceynowa moderated a discussion of the FASB’s new revenue recognition standard and auditing issues related to revenue. The discussion included an overview of the PCAOB’s recent [Staff Audit Practice Alert No. 12](#), which notes that the PCAOB has observed audit deficiencies in the following areas (these are expected to be continuing areas of focus for the PCAOB in its inspections process and for auditors):

- Evaluating revenue recognition from contractual arrangements.
- Auditing gross versus net presentation of revenue.
- Evaluating whether revenue was recognized in the correct period.
- Auditing disclosures about revenue.
- Responding to risks of material misstatement due to fraud associated with revenue.
- Testing and evaluating controls over revenue.
- Applying audit sampling procedures to test revenue.
- Performing substantive analytical procedures to test revenue.
- Testing revenue in companies with multiple locations.

In addition, FASB Board Member Larry Smith provided an update on the FASB’s new revenue standard and the work of the joint transition resource group (TRG) on revenue recognition. Also, various SAG members provided their observations about whether the PCAOB should consider adding guidance or standards on auditing revenue. PCAOB staff members pointed out that the auditing matters discussed in the Staff Audit Practice Alert are believed to be relevant to auditing revenue under both current accounting standards and the new accounting standard. Several SAG members urged the PCAOB to take a “wait and see” approach and allow time for thoughtful implementation of the accounting standard and for related issues to be worked out before considering any potential changes to the auditing standards. Others raised concerns about what the PCAOB may expect of auditors in terms of documenting significant assumptions as a result of applying the new revenue recognition standard.

Editor’s Note: Mr. Smith responded to some concerns about implementation issues associated with the new standard. He noted that the TRG discussed about 10 out of the approximately 25 questions that it has received thus far. He further noted that, as a result of the TRG discussion, the FASB staff is currently conducting research on several of the issues, which may result in discussion among FASB Board members and potential guidance in the future (e.g., how to apply the definition of a “distinct performance obligation” and revenue recognition for licenses). Mr. Smith also noted that the FASB plans to obtain feedback from preparers of financial statements about their readiness to implement the standard and that its considerations about the potential need to defer the standard’s effective date will take into account that feedback. The PCAOB attends TRG meetings as an observer and will evaluate auditing and internal control issues related to revenue as they arise.

Given the recent discussions and comments by the PCAOB staff related to fraud, it is possible the PCAOB may consider some action in this area (e.g., a discussion paper).

Auditing Accounting Estimates and Fair Value Measurements

Associate Chief Auditor Barbara Vanich provided an overview of 39 comment letters received on the [PCAOB Staff Consultation Paper, Auditing Accounting Estimates and Fair Value Measurements](#) (the “consultation paper”), which was issued in August 2014. The consultation paper explores the possibility of the PCAOB’s development of a single standard on auditing accounting estimates, including fair value measurements, and related disclosures. The consultation paper states that such a standard would be developed to align with the requirements of the PCAOB’s risk assessment standards, to establish consistent requirements for auditing both management estimates and fair value, and to establish specific requirements regarding the use of third parties.

On the basis of the discussion at the SAG meeting, commenters generally supported the Board’s efforts to examine its existing standards on this topic.² However, commenters expressed mixed views on several issues, including whether the PCAOB should develop a single standard or retain multiple standards on management estimates and fair value. Themes of the comments included the following:

- Preference for a principle-based standard and supplemental guidance on specific issues, as necessary.
- Suggestions that the PCAOB work with other regulators and standard setters to address challenges that affect both auditors and management, such as wide ranges of measurement uncertainty and the use of pricing services.
- Suggestions that the PCAOB consider the following in addition to the topics in the consultation paper:
 - Addressing when measurement uncertainty is greater than materiality.
 - The importance of reconsidering the PCAOB’s standard on using the work of specialists in connection with considering a new standard on auditing accounting estimates and fair value measurements.
 - How to weight audit evidence when some evidence supports and other evidence contradicts management’s estimate.
 - The potential need for additional disclosures about measurement uncertainty, which would be provided either by management in the financial statements or by the auditor in the auditor’s report.
- General support for further integrating the potential standard with the risk assessment standards (e.g., providing guidance on assessing risk for certain types of estimates).
- General support for retaining the three approaches for auditing management estimates: (1) testing management’s process, (2) developing an independent estimate, and (3) reviewing subsequent events or transactions.
- General support for recognizing differences in how third parties are involved in audits. However, views differed on how to address the use of third parties, and there was a range of perspectives on the extent of testing required by the auditor.

Commenters expressed mixed views on whether the PCAOB should develop a single standard or retain multiple standards on management estimates and fair value.

Editor’s Note: The PCAOB staff plans to finalize its analysis of the comments received and to have discussions with the Board before developing a proposed standard for public comment. The PCAOB did not indicate when the proposed standard might be issued.

² This topic was also discussed at the October 4, 2014, SAG meeting.

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