

AUDIT COMMITTEE DIALOGUE

The PCAOB and audit committees share a common interest in audit quality. In our talks with audit committee members, we heard your request to provide insights from our oversight activities.

As a result of regularly inspecting more than 650 audit firms, including annually inspecting the largest firms, we are in a unique position to develop insights that may be helpful to audit committee members in your ongoing dialogue with and oversight of their auditors.

Our inspectors have recently embarked on our 2015 inspections. As they do each year, they have been considering two broad questions: What recurring audit concerns identified in past inspections are expected to continue to be significant? And what emerging audit risks might require increased

focus by auditors and audit committees in the future?

Audit committees have a range of important responsibilities, and we know your time is at a premium. We highlight here key areas of recurring concern in our inspections of large firms and certain emerging risks that we see. Although our inspections take place only after audits are complete, we hope these insights will be useful to audit committees in your 2015 oversight activities. You may also find these insights useful in your interactions with management. We look forward to continuing our conversation, as you are key stakeholders in strengthening audit quality.

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Key Recurring Areas of Concern

In recent years, our inspections of member firms of six large global networks¹ have frequently found significant deficiencies in the following areas that may be of concern to audit committees:

- Auditing internal control over financial reporting (ICFR)
- Assessing and responding to risks of material misstatement
- Auditing accounting estimates, including fair value measurements
- In cross-border audits, deficient “referred” work — work performed by other audit firms and used by the signing audit firm

Each of these areas is discussed briefly below.

Areas of Most Frequently Identified Deficiencies



Of all relevant audits inspected (as detailed in separate tables below), percentage in which Inspections staff identified, in the specified area, auditing deficiencies that resulted in insufficiently supported audit opinions. (*Risk assessment* deficiencies relate to auditing standards that were not in effect for audits inspected before 2012.)

* Estimates other than fair value.

1. The compiled inspection results presented in this document relate to information included in publicly available PCAOB inspection reports on member firms of the six global networks that include large U.S. firms and the largest number of PCAOB-registered non-U.S. firms: BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative, and PricewaterhouseCoopers International Limited.

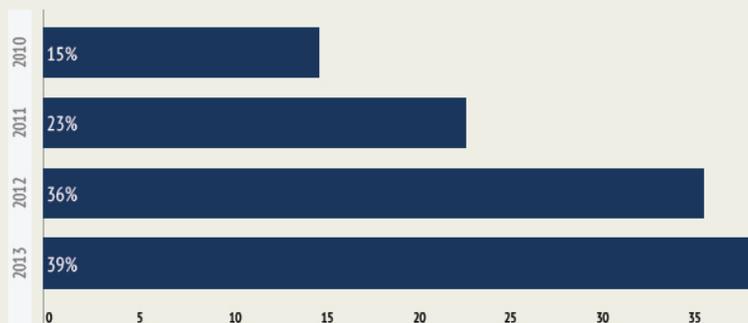
1. Auditing internal control over financial reporting

Effective internal control over financial reporting can help to prevent material misstatements and the need for costly restatements. Properly executed, an audit of ICFR could help inform the audit committee of material weaknesses and may also identify other significant deficiencies in ICFR, so that they can be addressed. Indeed, promoting effective internal control may be one of the best ways an audit committee can help the company be prepared for both anticipated and unanticipated opportunities or challenges.

High quality audits of ICFR should provide audit committees important information about the condition of a company's ICFR and the risk of future financial reporting problems. A properly executed audit of ICFR should identify an existing material weakness even if it has not yet resulted in a material misstatement.

Our inspections find a high rate of deficiencies in audits of ICFR. We often find that the auditor did not perform sufficient procedures to test the effectiveness of controls. In cases where auditors have

Deficiencies in Audits of ICFR



Of all integrated audits inspected, percentage in which inspections staff identified deficiencies in auditing ICFR that resulted in an insufficiently supported audit opinion.

identified deficiencies in controls, we sometimes find that the auditor did not sufficiently evaluate whether the identified deficiencies constituted material weaknesses. We are encouraged by recent improvements in this area at some firms, but continue to find a high rate of deficiencies at other firms.

Audits of ICFR don't achieve their objectives if material weaknesses remain undetected until a material misstatement occurs and highlights it. Independent of our inspection observations, Audit Analytics has compiled data from SEC filings that suggest something about the frequency with which that occurs:

- 77 percent of the audit opinions issued in the last two completed reporting years (2012 and 2013) that stated

that a material weakness in ICFR had been identified were issued either after, or in connection with, the issuer's disclosure of a related financial reporting error that the issuer addressed through a restatement or an adjustment, including cases in which the error came to the attention of the issuer from outside of the financial reporting process, such as through regulatory investigations and whistleblower activity.²

- In 83 percent of the restatements announced during 2013 and 2014 by companies required to report on ICFR, no material weakness was reported in the ICFR opinion preceding the announcement.³

2. This figure is based on a review of Audit Analytics® data to identify ICFR audit opinions that identified material weaknesses and a review of the relevant companies' SEC filings.

3. This figure is based on the number of restatements announced in a Form 8-K or a Form 6-K and a review of the most recent preceding ICFR audit opinions for those companies.

Potential Questions for Your Auditor

- What are the points within the company's critical systems processes where material misstatements could occur? How has the audit plan addressed the risks of material misstatement at those points? How will your auditor determine whether controls over those points operate at a level of precision that would prevent or detect and correct a potential material misstatement?
- What is your auditor's approach to evaluating the company's controls over financial reporting for significant unusual transactions or events, such as the acquisition of assets and assumption of liabilities in a business combination, divestitures, and major litigation claims?
- If the company enters into a significant unusual transaction during the year, how will your auditor adjust the audit plan, including the plan for testing ICFR related to the transaction? For example, how would the company's acquisition of a significant enterprise during the third quarter affect the audit plan for the year? How might your auditor's materiality assumptions change? Would the audit plan focus on different systems and controls than originally planned? How would your auditor test controls over the systems used to generate information for recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree? How would the internal control over financial reporting of the acquired company be considered? Asking about the effectiveness of controls before such transactions and events occur will signal to your auditor that preparedness is a priority, as will asking similar questions about new systems and processes.
- If the company or your auditor has identified a potential material weakness or significant deficiency in internal control, what has been done to probe the accuracy of its description? Could the identified control deficiency be broader than initially described? Could it be an indication of a deficiency in another component of internal control?



2. Assessing and responding to risks of material misstatement

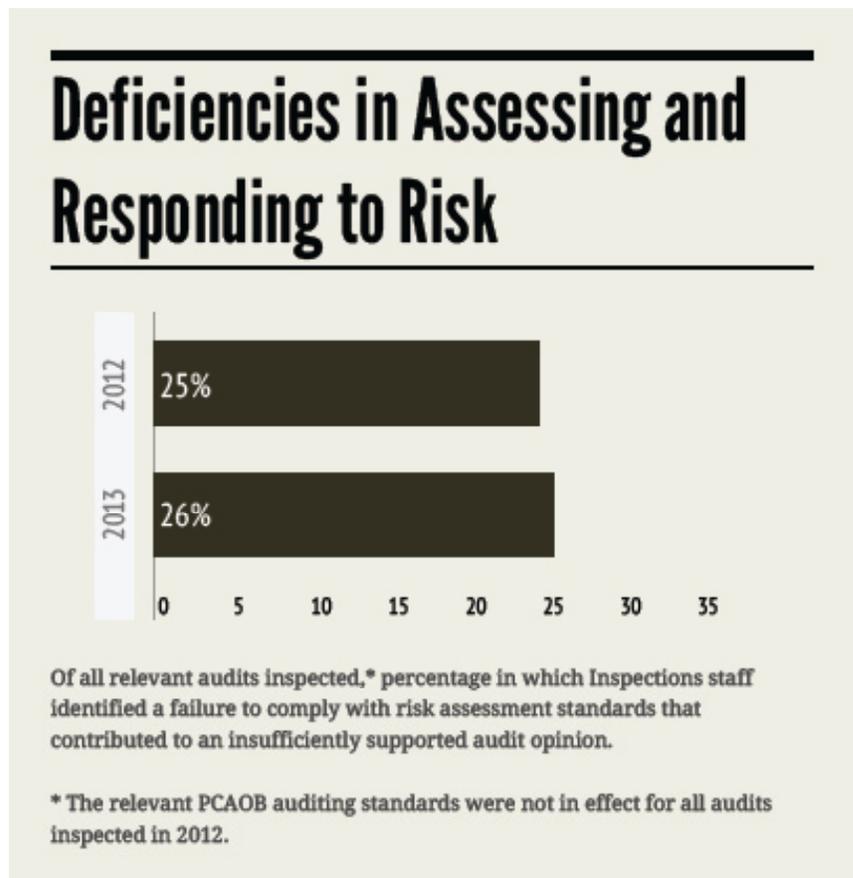
Assessing and responding to risks of material misstatement are critical activities in an audit. Many auditors do an effective job. But some auditors do not always identify the risks they should identify or respond effectively to existing risks that they have identified. This is particularly true with respect to auditing revenue, an area that often involves significant risks, including fraud risks.

We have the following insights to offer from our experience evaluating deficiencies in auditors' responses to assessed risks:

- When risks change, audit plans should as well. A transaction or location that wasn't material in the past may now be (or vice versa). Your auditor should conduct a rigorous analysis of changes in the company's business and its environment as part of its risk assessment process and then be able to describe to you how this year's audit plan addresses those changes.

- In integrated audits of large companies, PCAOB inspectors have seen audit plans that provide for insufficient audit procedures at certain locations or business segments that are significant contributors to the results of operations and involve higher risk of material misstatement of the financial statements. The explanation for this is usually that the auditor relied on entity-level controls to cover those

locations or businesses. To employ that approach, it is important that auditors test those entity-level controls, along with controls over the related data used, and evaluate whether the controls are precise enough to address the relevant risks. Some auditors also assume that controls are uniform across locations, without a basis for such a conclusion, which may also lead to insufficient audit work.



Potential Questions for Your Auditor

- Which audit areas are designated by your auditor as having significant risks of material misstatement and what audit procedures are planned to address those risks?
- In your auditor's view, how have the areas of significant risk of material misstatement changed since the prior year? What new risks has your auditor identified? What is your auditor's process to make sure that it identifies new or changing risks of material misstatement and tailors the audit plan appropriately? How is the engagement partner involved?
- How does your auditor's audit plan address the varied risks in a multi-location environment? If your auditor assumes that controls are uniform across multiple locations, how does your auditor support that assumption?
- If the company has operations in countries that are experiencing political instability, how has your auditor identified and addressed the specific risks that might result from such a circumstance? Or, if some of the company's products are approaching technological obsolescence due to competitive new products, you might ask how your auditor plans to address the risks of inventory obsolescence.



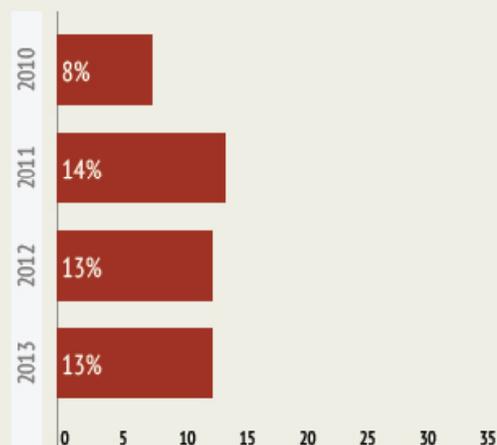
3. Auditing estimates, including fair value measurements, and disclosures

Accounting estimates warrant significant audit attention because they involve subjective factors and judgments, which make them susceptible to management bias and material misstatement.

Inspectors have identified a large number of significant deficiencies in the auditing of accounting estimates over many years in areas such as revenue, allowances for loan losses, inventory reserves, fair value measurements, and tax-related estimates. Auditors also need to pay close attention to the identification and evaluation of indicators of asset impairments, particularly when economic conditions deteriorate.

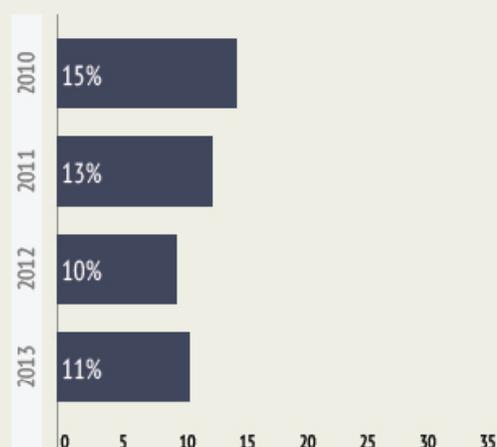
Fortunately, inspectors have seen positive remedial steps in this area. Nevertheless, inspectors continue to see significant deficiencies, including auditors' testing of related controls. Inspectors also continue to identify audit deficiencies when auditors have not sufficiently evaluated available information that appeared to be contrary to the information management used to support its estimates, including, for example, cash flow forecasts used in the budgeting process that differ from those used to determine the fair value of intangible assets for purposes of assessing whether those intangible assets or goodwill is impaired.

Deficiencies in Auditing Accounting Estimates



Of all audits inspected, percentage in which Inspections staff identified deficiencies in auditing estimates, other than fair value measurements, that resulted in an insufficiently supported audit opinion.

Deficiencies in Auditing Fair Value Measurements



Of all audits inspected, percentage in which Inspections staff identified deficiencies in auditing fair value measurements that resulted in an insufficiently supported audit opinion.

Potential Questions for Your Auditor

- What does your auditor do to obtain a thorough understanding of the assumptions and methods the company used to develop critical estimates, including fair value measurements?
- What is your auditor's approach to auditing critical accounting estimates, such as allowances for loan losses, inventory reserves, and tax-related estimates?
- How has your auditor assessed whether management has identified all separable intangible assets that, while not included in the financial statements, must nevertheless be valued in connection with assessing goodwill for possible impairment (e.g., customer-related intangibles and in-process research and development)? Has your auditor considered contrary information that suggests the existence of such assets that management has not identified?
- Will your engagement team use its firm's in-house valuation specialists? If so, how are the specialists integrated into the engagement team? How are specialists supervised, and how are significant issues they identify resolved? If the firm does not have in-house valuation specialists, does the firm engage external specialists to assist the auditor with their audit of complex estimates?



4. Referred work in cross-border audits

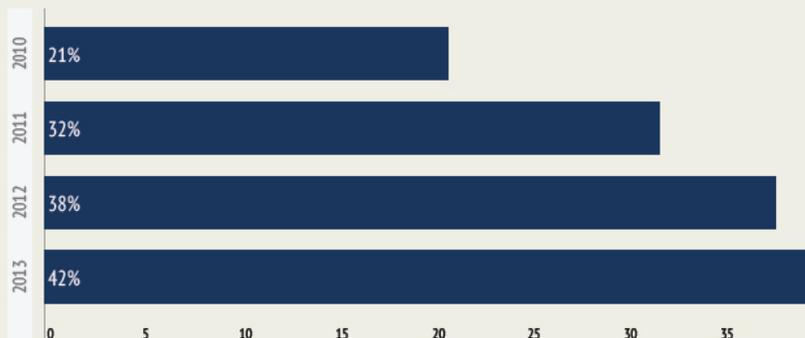
When auditing a multi-national company, the signing (or principal) auditor usually refers portions of the audit work (so-called “referred work”) to other firms, which are usually affiliated firms, that are located in the foreign countries where the company has operations. In such cases, the quality of the referred work can be critical to determining whether the financial statements are free of material misstatement and, if required, whether the company’s internal control over financial reporting is effective.

The PCAOB has inspected audit firms in 45 non-U.S. jurisdictions. In addition to examining work performed by these firms as the signing auditor for SEC reporting issuers located in their jurisdiction, our inspectors examine referred work performed by these firms. At some of these firms, the referred work is a significant part of their practice related to issuers.

In 2013, inspectors found significant problems in more than 40 percent of the

referred-work engagements they inspected at non-U.S. member firms of the six networks mentioned above. Although the results of some 2014 inspections are still being evaluated, the 2014 inspections continued to identify deficiencies in referred-work engagements. These deficiencies showed up in the testing of such critical areas as revenue, inventory, and controls — frequently in circumstances where the revenue, inventory, or controls in question were significant to the issuer’s consolidated financial statements or the issuer’s overall ICFR, and the results reported by the other auditor formed part of the basis for the signing firm’s opinion.

Deficiencies in Non-U.S. Referred Work



Of all referred work engagements inspected, percentage in which Inspections staff identified deficiencies that resulted in the firm failing to fulfill the objectives of its role in the audit.

Where PCAOB Has Inspected

Argentina	Malaysia
Australia	Mexico
Belize	Netherlands
Bermuda	New Zealand
Bolivia	Nicaragua
Brazil	Norway
Canada	Panama
Cayman Islands	Papua New Guinea
Chile	Peru
Colombia	Philippines
Denmark	Russian Federation
Finland	Singapore
France	South Africa
Germany	Spain
Greece	Sweden
Hong Kong	Switzerland
India	Chinese Taipei (Taiwan)
Indonesia	Thailand
Ireland	Turkey
Israel	Ukraine
Japan	United Arab Emirates
Kazakhstan	United Kingdom
Republic of Korea	

Potential Questions for Your Auditor

- How does the engagement partner assess the quality of the audit work performed in other jurisdictions? Were the firms that participate in the audit recently inspected by the PCAOB? If yes, what does the engagement partner know about the results?
- How does your auditor review the work? Does your auditor visit other countries to review the audit work done there? What steps does your auditor take to make sure that the work is performed by persons who understand PCAOB standards and U.S. GAAP and financial reporting requirements?
- As part of planning the audit, does your auditor consider performing additional steps if the referred work is in an area that has recently been the subject of a significant number of PCAOB inspection findings on your auditor?



New Risks the PCAOB is Monitoring

The landscape for public companies is constantly changing, and our inspectors take this into consideration when planning the year's audit inspections.

In addition to considering risks based on recurring areas of audit deficiencies, such as those discussed above, we also consider indicators of potential emerging areas of audit risk. Here are some of the indicators of potential emerging risks that are informing our inspection planning for this year:



Increase in mergers & acquisitions

High cash levels, low interest rates, and shareholder pressure for growth have stimulated a level of merger and acquisition activity not seen for some time. More experienced members of the engagement team usually handle audit procedures for business combinations, yet problems still arise. In addition, while the revised business combination accounting standards have been in place for more than five years, even senior members of the audit team may lack sufficient experience in this area due to the relatively low level of merger and acquisition activity until recently. Inexperience may lead to the auditor failing to detect material misstatements in the accounting for a business combination.

PCAOB inspectors have observed a range of deficiencies related to auditing business combinations. For example, in some cases, auditors have relied on controls without testing them. Inspectors have also observed auditors failing to test company-produced data that are used to prepare cash flow projections to support fair value measurements. In other cases, auditors have failed to detect that management had not identified all the intangible assets that needed to be valued, such as customer-related intangible assets.

Potential Questions for Your Auditor



- Does your auditor have the expertise necessary to address the audit issues that may arise from the reporting requirements related to business combinations as well as other effects of a business combination that may bear on financial reporting, such as the effects on segment reporting? If not, how will your auditor obtain or develop that expertise?



Falling oil prices

The decline in oil prices in the past year raises a variety of audit issues. PCAOB inspectors plan to examine how auditors approach the risks of material misstatement resulting from changes in oil prices. These risks are not solely applicable to companies in the oil and gas industry, but also to other companies, regardless of whether they are directly or indirectly part of the supply chain to the oil and gas industry. Specific areas of focus include impairment and valuation issues and the collectability of loans and receivables.

Potential Questions for Your Auditor



- Have declining oil prices been identified as a risk factor and changed your auditor's approach to testing related accounting estimates? Will your auditor require different evidence to support any assumptions and estimation methods used by the company that may depend on a certain level of oil prices?
- How might the estimated effects of falling oil prices be factored into estimates of the company's future undiscounted net cash inflows used in the assessments of possible impairments of long-lived assets? How might those effects affect the possible need for recording or adjusting a deferred tax valuation account?
- Does the decline in oil prices create a need to disclose certain significant risks and uncertainties in the financial statements? Do oil price movements subsequent to year-end represent a subsequent event that requires disclosure in the company's financial statements?



Undistributed foreign earnings

U.S. public companies collectively hold more than \$2 trillion⁴ in undistributed foreign earnings that the managements of those companies assert will be indefinitely reinvested outside the U.S., thus avoiding financial reporting provisions for U.S. federal and state income taxes on such earnings. PCAOB inspectors have found problems in the auditing of management's assertion, including the failure to evaluate the impact on that assertion of significant cash transfers from a foreign subsidiary to the U.S. parent. Inspectors have also seen problems in auditing controls over income tax accounting, generally, and related disclosures.

You should keep in mind that a conflict of interest between the company and your auditor could arise if the company faces legal liability or sanctions based on a tax strategy developed by your auditor. Such a conflict could affect your auditor's ability to continue as the independent auditor, and the timing of such a change could be inconvenient. Audit committees may find it useful to keep a list of past tax strategy engagements and monitor the list for potential effects on the audit.

Potential Questions for Your Auditor



- What is the nature and extent of audit evidence gathered by your auditor related to management's assertions about indefinite reinvestment? Is there contrary evidence? If so, how did your auditor consider the contrary evidence?
- Has your auditor considered whether the company's MD&A disclosure, including disclosure regarding liquidity and capital resources, is consistent with, or contradicts, management's indefinite reinvestment assertion?

4. Source: Audit Analytics®, Foreign Indefinitely Reinvested Earnings: Balances Held by the Russell 1000 – A 7-Year Snapshot (April 2015), <http://www.auditanalytics.com/0000/custom-reports.php>.



Maintaining audit quality while growing other business

Audit firms currently do significantly less non-audit work for issuer audit clients than they did prior to the turn of the century. Nevertheless, each of the largest firms continues to maintain non-audit services lines of business. Recently, several firms have acquired significant consulting firms to grow certain consulting services. Each of the Big Four firms, for example, has in recent years experienced an increase in the percentage of its revenue that comes from advisory services and a decrease in the percentage of its revenue that comes from assurance services.⁵

Even when an audit firm does not provide significant non-audit services to a particular issuer audit client, we are concerned about the effects such business developments may have on the firm's attention to audit quality. Depending upon how a firm manages that growth, there is a risk that the culture within a firm could tend to drift from a focus on audit quality to a focus that subordinates audit quality to other business opportunities and challenges. That would undermine the PCAOB's and audit committees' interest in high quality audits.

Potential Questions for Your Auditor



- Has your engagement team been affected by any changes in the firm's business model? Has the engagement team lost key auditors or specialists to other lines of business? How are you ensuring that the quality of the audit team will remain high over time?

5. Source: Transparency reports issued by Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP for years 2011 to 2014.

Keep This Dialogue Going

Tap into more PCAOB insights

If you would like to receive future PCAOB updates on other topics and/or specific ones targeted to audit committee members, please [sign up on our website](#).

If you would like to contact us, please [send us a message on our website](#).