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Report from the Working Group on PCAOB Publications

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PCAOB Publications

- ❑ Staff Consultation Paper (SCP), *Auditing Accounting Estimates and Fair Value Measurements* (August 19, 2014)
- ❑ PCAOB Concept Release No. 2015-005, *Audit Quality Indicators* (July 1, 2015)
- ❑ Staff Consultation Paper No. 2015-01, *The Auditor's Use of The Work of Specialists* (May 28, 2015)

PCAOB Publications

Introduction

- ❑ Estimates, fair value measurements, the auditor's use of specialists, and the proposed audit quality indicators matter to investors because they are critical components of financial statements and significantly influence investors' perception of, and confidence in, the integrity of financial statements.
- ❑ Certain current standards were developed nearly three decades ago in response to significant problems in the financial industry. The Paulson Commission's recommendation to establish AQIs remains unresolved 8 years later.
- ❑ More recent business models and reporting standards have added several layers of complexity to nearly all accounting estimates and, even more significantly, to fair value measurements.
- ❑ The Working Group was asked to provide investors' perspectives on these issues and recent related PCAOB publications.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Recommendations

- ❑ Prescribe auditor disclosures that enhance transparency and enable sensitivity analyses of estimates in financial statements.
- ❑ The current optional development of an expectation of estimates should be mandatory. The auditor should be required to use market data to audit estimates, compare management estimates to actual results and report these findings to the audit committee and investors.
- ❑ Require audits of the internal controls on the process of developing estimates and fair value measures.

PCAOB Publications – Audit Quality Indicators

Recommendations

- ❑ Information on the firm leadership and the firm's governance structure,
- ❑ Regulatory enforcement actions against the firm, violations of auditor independence, and disciplinary actions against audit partners, and
- ❑ Firm revenue by business segment, cross-subsidies, and investment of resources in technology and training, both within the audit practice specifically and firm-wide.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Recommendations

- ❑ Strengthen guidance of and require incremental disclosure of the auditor’s use of employed and engaged specialists particularly on issues related to the objectivity and integrity of the work of the specialist.
- ❑ More specific guidance is needed on the supervision of the work of the specialists.
- ❑ Require auditor-audit committee communications related to the auditor’s use and audit of the work of specialists.
- ❑ Provide Investors better disclosure of the use and audit of the work of specialists.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Background

- ❑ Fair value measures are difficult to audit but reliable fair values are essential to understanding management decisions and financial statements.
- ❑ Primary sources of financial statement errors involving estimates (not an exhaustive list):
 - Management bias in the development of estimates,
 - Auditors often audit to management estimates eschewing (1) challenges to management assertions and data, and (2) the development of independent estimates and recourse to external data, and
 - A lack of understanding of the client's business, the economic rationale underlying the transactions, and the control environment at the client. This shortfall often extends to the audit engagement partner.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Background

- ❑ The KPMG Comment letter to this SCP notes the utility of external data in the evaluation of management estimates.
- ❑ Financial analysts and asset managers also use such data for similar purposes in making their investment decisions.
- ❑ The 2013 CFA Institute comment letter to the PCAOB on the auditor's reporting model cited consistent findings from multiple surveys of the importance investors place on the audit report. The survey results also highlight the call for more information on the basis for the auditor's opinion.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Background

- Investors have long noted that the audit team and its leader must have sufficient knowledge of and experience in:
 - Industry, business model, and transaction types,
 - Applicable financial reporting framework,
 - Needed documentation for above transactions and framework, and
 - Internal controls framework for the above.

- Auditors also need to understand how investors use financial statement data in investment decisions.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Recommendations

- Prescribe auditor disclosures that enhance transparency and enable sensitivity analyses of estimates in financial statements including:
 - Range and dispersion measures of observations used to derive estimates.
 - Assumptions having a significant or material effect on the financial statements.
 - Information material to the financial statements but not otherwise required by reporting and regulatory standards.
 - Highlight income statement consequences of non-cash adjustments to reserves and other balances in the performance statement.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Recommendations

- ❑ The current optional development of an expectation of estimates (See AU sec. 342 and ISA 540 auditing standards) should be mandatory.
- ❑ Management should disclose more modeling information to enable auditors to test the level of and trends in the accuracy of prior estimates and these analyses should be reported to stakeholders.
- ❑ Auditors should be required to critically judge management estimates using independently sourced relevant market data including changing trends.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Recommendations

- ❑ The Audit partner and team must have sufficient expertise in the economics underlying the business models and transactions used by the client in developing estimates.
- ❑ Auditors should test and report on the internal controls and the relevance, reliability, and appropriateness of the models, data, and assumptions underlying the process of management's development of estimates.
- ❑ We strongly recommend the PCAOB require the use of objective (external) data in audits of estimates.

PCAOB Publications – Auditing Accounting Estimates and Fair Value Measurements

Recommendations

- ❑ Auditors should be required to obtain evidence needed to audit disclosures and this assessment should be separately reported by the auditor to the audit committee and other stakeholders through the audit report.
- ❑ The PCAOB should develop audit standards using these requirements. It should work with the SEC to ensure that the FASB issues these disclosure requirements to ensure improvements in audits of accounting estimates and fair value measurements.

PCAOB Publications – Audit Quality Indicators

Background

Need for AQI

- ❑ They provide a basis for measurement and management of audits,
- ❑ Help investors and the audit committee compare audit quality and select audit firms, and
- ❑ Assist the PCAOB to monitor catastrophic risk.

PCAOB Publications – Audit Quality Indicators

Recommendations

- ❑ Information on the firm leadership and how it is selected,
- ❑ Comprehensive discussion of the firm's governance structure, and
- ❑ Ratio of audit staff to partners.

PCAOB Publications – Audit Quality Indicators

Recommendations

- ❑ A list of qualified reports on the audit firm's internal controls and enforcement actions imposed by the SEC, the PCAOB, or other regulators and the corrective actions taken in response by the firm,
- ❑ Any violation of auditor independence rules and any disciplinary actions against the audit partner,
- ❑ Percentage of audit reports on internal controls that reported a material weakness, and
- ❑ A three-year moving average of practice protection costs related to the audit practice.

PCAOB Publications – Audit Quality Indicators

Recommendations

Within the audit practice specifically and firm-wide:

- ❑ Total revenue and revenue disaggregated by business line,
- ❑ Profit sharing and subsidies provided by specific business segments to other segments, and
- ❑ Percentage of firm's revenues invested in (a) technology, and (b) training.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Background

- ❑ Increasingly complex contracting, transactions, and innovative companies, proposed or recently issued standards requiring specialized estimates and valuation, and resulting data complexity have increased the perceived risks of misstatements in financial statements.
- ❑ The innovative internet-based business models of many social media-related and high-technology companies present complex audit problems.
- ❑ The newer class of intangible and intellectual property assets raise varied and less understood valuations challenges.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Background

- ❑ The auditor’s use of specialists raises critical questions about the objectivity and transparency in and the reliability of the financial statements.
- ❑ An auditor’s *employed* specialist must be independent of the company being audited, whereas an auditor’s *engaged* specialist is not required to be independent of the company being audited.
- ❑ We encourage the staff’s efforts to learn more about the firms’ audits of their clients’ proprietary valuation models.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Background

PCAOB Staff Observations:

- ❑ Fair value measurements may be audited by testing the significant assumptions used by the company and its employed or engaged specialists, valuation models, and underlying data.
- ❑ “Hand-off” Issues: The auditor may not (1) reach an agreement with the specialist as to scope of the work to be performed by the specialist, (2) adequately assess the work done by the specialist (or, may not have the requisite expertise to do so), and (3) resolve discrepancies/differences reported by the specialist.
- ❑ Multiple specialists were used in the majority (90%) of audits of large, global accounting firms and the specialists work on more than area of expertise on each audit. The scale of the problem seems lower in audits by smaller firms.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Background

- ❑ AU Section 328 requires the auditor to evaluate the reasonableness of the company’s specialist. Standards on supervision of the audit engagement do not contain specific guidance on the use of the work of specialists. With the exception of Footnote 34 to AU sec. 336, there is little guidance on “hand-off” issues.
- ❑ The 2013 IAASB post-implementation review reported problems with inconsistent and insufficient procedures used by auditors with respect to work done by specialists.
- ❑ PCAOB inspections noted cases where auditors did not follow AU sec. 336 procedures when using the work of specialists. SEC and PCAOB enforcement examples of (1) material misstatements in financial statements due, in part, to the use of work done by specialists, and (2) non-compliance by auditors.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Recommendations

- ❑ The PCAOB should strengthen guidance of and require incremental disclosure of the auditor’s use of specialists in general (for example, the use of employed versus engaged specialists), and specifically, the use of specialists employed by the company being audited.

- ❑ Auditors need more specific guidance on:
 1. The use of the work of specialists,
 2. Auditor-specialist communications,
 3. AU sec. 336.

PCAOB Publications – The Auditor’s Use of The Work of Specialists

Recommendations

- ❑ The Board should specify auditor communication with and disclosures to the audit committee with respect to the use and the audit of the work of the specialist.
- ❑ The auditor should be required to disclose information relating to the potential impairment of the specialist’s objectivity, including fees for services unrelated to the audit (both in absolute terms and as a percentage of total revenues).

PCAOB Publications

Questions



PCAOB Publications

Open Discussion