



## **I. Introduction**

The Board is reproposing a new auditing standard, *Communications with Audit Committees* (the "new proposed standard"), and related amendments that would replace interim standards AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), and AU sec. 310, *Appointment of the Independent Auditor* ("AU sec. 310"). The new proposed standard, if adopted, would benefit investors by establishing requirements that enhance the relevance and quality of the communications between the auditor and the audit committee.<sup>1/</sup> The requirements in the standard are aligned with the requirements of the Sarbanes-Oxley Act of 2002 (the "Act") and enhance the requirements in the Board's existing standards.

Communications with the audit committee help the auditor improve the audit<sup>2/</sup> by (i) informing the audit committee, which has responsibility for the oversight of financial reporting, about significant matters related to the audit and the financial statements, (ii) enabling the auditor to obtain the audit committee's insights and information about transactions and events, (iii) enabling the auditor to learn about complaints regarding accounting or auditing matters, and (iv) assisting the auditor in gaining a better understanding of the company and its control environment, among other things. For many public companies, the Act served to strengthen and expand the role of the audit committee in the financial reporting process. For example, the Act requires that audit committee members of listed companies be independent and that audit committees be responsible for the appointment, compensation, and oversight of the work of the external auditor for the purpose of preparing or issuing an

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<sup>1/</sup> The term "audit committee," as used in the new proposed standard and this release, refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to a company, those persons designated to oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

<sup>2/</sup> For purposes of this standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

audit report or related work.<sup>3/</sup> These requirements place the audit committee at the center of the relationship between management of a public company and its auditor.

Audit committees play an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to company shareholders and others to oversee the integrity of a company's financial statements and the financial reporting process. An audit committee that is well-informed about accounting and disclosure matters relating to the audit may be better able to carry out this role. One way the audit committee may be informed of accounting and disclosure matters is by receiving communications containing the auditor's evaluations of matters that are significant to the financial statements. Therefore, the new proposed standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process. Effective two-way communication between the auditor and the audit committee on such relevant matters will benefit the auditor in performing an effective audit.

Effective communication between the auditor and the audit committee may involve many forms of communication, such as presentations, charts, written reports, or robust discussions. As described in the new proposed standard, the term, "communicate to" is meant to encourage effective two-way communications between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit. Communications that are tailored to the circumstances and informative, rather than "boiler-plate" or standardized, will enable the auditor and the audit committee to engage in a dialogue that is more likely to benefit the audit committee in conducting its oversight responsibilities and the auditor in conducting an effective audit.

## **II. Background**

On March 29, 2010, the Board proposed a standard, *Communications with Audit Committees* (the "original proposed standard"), to enhance the relevance and effectiveness of the communications between the auditor and

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<sup>3/</sup> See Section 301 of the Act of 2002, section 301 and Section 10A (m)(2) and (3) of the Securities Exchange Act of 1934 ("Exchange Act").

the audit committee.<sup>4/</sup> The Board received 35 comment letters on the original proposed standard.<sup>5/</sup>

Most commenters were supportive of the original proposed standard, although several commenters suggested that additional outreach to stakeholders might be beneficial. The comments received were discussed with the Board's Standing Advisory Group ("SAG") on July 15, 2010.<sup>6/</sup> Additionally, on September 21, 2010, the Board held a roundtable to obtain additional insight from stakeholders, including investors, audit committee members, auditors, and preparers.<sup>7/</sup> The roundtable discussion explored many key issues that commenters had raised in response to the original proposed standard regarding:

- i. Communications beneficial to audit committees,
- ii. Accounting policies, practices, and estimates,
- iii. Effective two-way communication between the auditor and the audit committee,
- iv. Balance between written and oral communications,
- v. Audit committee responsibilities in the engagement letter,
- vi. Management communications, and

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<sup>4/</sup> PCAOB Release No. 2010-001, *Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards* (March 29, 2010).

<sup>5/</sup> Comments on the original proposed standard are available on the Board's Web site at:  
<http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx>.

<sup>6/</sup> A transcript of the portion of the meeting related to the original proposed standard is available on the Board's Web site at:  
[http://pcaobus.org/Rules/Rulemaking/Docket030/Communications\\_with\\_Audit\\_Committees.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/Communications_with_Audit_Committees.pdf).

<sup>7/</sup> A transcript of the roundtable is available on the Board's Web site at: [http://pcaobus.org/Rules/Rulemaking/Docket030/Roundtable\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/Roundtable_Transcript.pdf).

vii. Uncorrected misstatements.

To provide all interested parties with an opportunity for additional comments on the topics discussed at the roundtable, the Board reopened the public comment period on the original proposed standard. The Board received eight additional comment letters during this extended comment period. Many commenters offered suggestions about how to improve the original proposed standard, which the Board has carefully analyzed.

The original proposed standard was revised in response to comments received in comment letters and at the roundtable. These revisions are described in Appendix 4 to this Release. The Board is reproposing the *Communications with Audit Committees* standard for the following reasons:

- On August 5, 2010, subsequent to the original proposal, the Board adopted eight standards, the "risk assessment standards" that serve as a foundation for future standard-setting.<sup>8/</sup> The new proposed standard aligns the audit committee communication requirements with the auditor performance requirements included in the risk assessment standards. Reproposing provides commenters with the opportunity to consider the new proposed standard in relation to the performance requirements in the risk assessment standards.
- On July 21, 2010, the Board was granted oversight of the audits of brokers and dealers registered with the U.S. Securities and Exchange Commission ("SEC" or "Commission").<sup>9/</sup> Specifically, the PCAOB now has the authority to carry out the same type of oversight responsibilities with respect to audits of brokers and dealers that it has carried out with respect to audits of issuers, including standard-setting. Reproposing the *Communications with Audit Committees* standard provides brokers and dealers,

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<sup>8/</sup> See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (August 5, 2010).

<sup>9/</sup> Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended various provisions of the Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

their auditors, and board members of brokers and dealers with an opportunity to comment on the new proposed standard.

- The new proposed standard adds a requirement for the auditor to communicate to the audit committee significant unusual transactions that are outside the normal course of business for the company or that otherwise appear to be unusual and to communicate the auditor's understanding of the business rationale for such transactions.

### III. **Improvements to PCAOB Standards**

Like the original proposed standard, the new proposed standard builds on the Act's definition of audit committee as a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the auditor's communication would be to those persons designated to oversee the accounting and financial reporting processes of the company and audits of financial statements of the company.

The new proposed standard improves the current requirements regarding auditor communications with the audit committee by linking the communication requirements to the related performance requirements in other auditing standards. It does not otherwise impose new performance requirements other than communications.

The new proposed standard improves and enhances current auditor communication requirements by:

- Requiring the auditor to establish an understanding of the terms of the audit engagement with the audit committee, record the terms of the engagement in an engagement letter, and have the engagement letter signed by the appropriate party or parties on behalf of the company and determine that the audit committee has acknowledged and agreed to the terms;

- Enhancing the auditor's inquiries of the audit committee regarding matters relevant to the audit, including, but not limited to, knowledge of violations or possible violations of laws or regulations and complaints or concerns raised regarding financial reporting matters;
- Requiring the auditor to communicate to the audit committee an overview of the overall audit strategy, including the significant risks the auditor identified, and to update the audit committee regarding significant changes to the planned audit strategy or identified risks;
- Requiring the auditor to communicate to the audit committee information about other independent public accounting firms or persons not employed by the auditor that are involved in the audit, if applicable;
- Requiring the auditor to communicate the basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
- Enhancing auditor communication with the audit committee regarding the company's accounting policies, practices, and estimates by aligning the communication requirements with auditor's performance requirements;
- Requiring the auditor to communicate to the audit committee difficult or contentious matters for which the auditor consulted outside the engagement team;
- Enhancing the communication with the audit committee regarding the auditor's evaluation of the quality of the company's financial reporting by aligning the communication requirements with the risk assessment standards and incorporating certain SEC communication requirements;
- Requiring the auditor to communicate significant unusual transactions and the auditor's understanding of the business rationale for such transactions;

- Enhancing the requirement for the auditor to communicate to the audit committee his or her views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters;
- Requiring the auditor to communicate to the audit committee his or her evaluation of going concern, if applicable;
- Requiring the auditor to communicate to the audit committee those situations in which the auditor concludes that a departure from the standard auditor's report is necessary;
- Requiring the auditor to communicate to the audit committee complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit;
- Requiring the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process; and
- Requiring the communications with the audit committee to occur before the issuance of the audit report.

In addition to the communication requirements included in the new proposed standard, other PCAOB standards and rules require the auditor to communicate specific matters to the audit committee, which are referenced in Appendix B to the new proposed standard. While the new proposed standard establishes certain requirements regarding auditor communications to the audit committee, the new proposed standard does not preclude the auditor from providing additional information to the audit committee. Nor does the new proposed standard preclude the audit committee from requesting additional information from the auditor.

#### **IV. Audits of Brokers and Dealers**

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>10/</sup> gave the Board oversight of the audits of brokers and dealers

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<sup>10/</sup> Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

registered with the SEC. In September 2010, the Commission issued interpretive guidance clarifying that the "references in Commission rules and staff guidance and in the federal securities laws to [Generally Accepted Auditing Standards] GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean" the auditing and attestation standards established by the American Institute of Certified Public Accountants (the "AICPA"), but noted that it intended to revisit this interpretation in connection with a Commission rulemaking project to update the audit and attestation requirements for brokers and dealers in light of the Dodd-Frank Act.<sup>11/</sup> On June 15, 2011, the SEC proposed to amend its rules to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.<sup>12/</sup> If the SEC adopts its proposed amendments to SEC Rule 17a-5, or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the Board's auditing, attestation, quality control, and, where applicable, independence standards would then apply to audits of brokers and dealers required by Section 17 of the Exchange Act and SEC Rule 17a-5.

The Board's current interim standard, AU sec. 380, which was last amended in 1999, is not applicable to audits of brokers and dealers if the broker or dealer does not have an audit committee<sup>13/</sup> or is registered only because of Section 15(a) of the Exchange Act.<sup>14/</sup> Under current requirements

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<sup>11/</sup> SEC, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, Exchange Act Release No. 62991 (September 24, 2010).

<sup>12/</sup> Exchange Act Release No. 34-64676 (June 15, 2011).

<sup>13/</sup> AU sec. 380.01 states that the communications required by AU sec. 380 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee).

<sup>14/</sup> See AU sec. 380.01, which states that the communications required by the standard "are applicable to . . . all Securities and Exchange Commission (SEC) engagements." As noted in footnote 2 to AU sec. 380.01,

contained in SAS 114, *The Auditor's Communication With Those Charged With Governance*, which was issued by the AICPA in 2006, auditor communication requirements are applicable to audits of brokers and dealers.<sup>15/</sup> Because of this difference in the applicability of the standards to the audits of brokers and dealers, there could be a gap in audit committee communications if the SEC amendments to SEC Rule 17a-5 are adopted and become effective prior to the effectiveness of the new proposed standard. To eliminate this gap, the Board is proposing a transitional amendment to revise its interim standard, AU sec. 380, to delete the current exception for audits of brokers and dealers that do not have an audit committee or are registered with the Commission only because of Section 15(a) of the Exchange Act. The proposed transitional amendment, which is contained in Appendix 2 to this release, would make the communication requirements in AU sec. 380 applicable to audits of issuers and brokers and dealers, as those terms are defined in the Act. This would eliminate the above referenced gap in audit committee communications.

The new proposed standard, which would supersede AU sec. 380, does not contain any exception as to applicability to audits of brokers and dealers. Accordingly, the communication requirements under the new proposed standard would be applicable to the audits of brokers and dealers.

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the audits of brokers and dealers do not fall within an SEC engagement as defined in AU sec. 380 if the broker or dealer is registered only because of Section 15(a) of the Exchange Act.

<sup>15/</sup> See paragraph 1 of SAS 114, *The Auditor's Communication With Those Charged With Governance*, which states "[t]his statement . . . establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements", and section 5.129 of the *AICPA Audit & Accounting Guide: Brokers and Dealers in Securities* (July 2010), which states, in part: "AU section 380, *The Auditor's Communication with Those Charged with Governance* ... has been updated for the issuance of SAS No. 114.... AU 380 is applicable to all broker-dealers being audited under GAAS, regardless of their governance structure or size."

**V. Appendices**

Appendix 1 to this release contains the text of the new proposed standard, *Communications with Audit Committees*, which has three appendices:

- (1) Appendix A - Definitions,
- (2) Appendix B - Communications with Audit Committees Required by Other PCAOB Rules and Standards, and
- (3) Appendix C - Matters Included in the Audit Engagement Letter.

Appendix 2 to this release contains the transitional amendments to AU sec. 380. Appendix 3 to this release contains amendments to other existing PCAOB standards to conform them to the requirements in the new proposed standard. Appendix 4 provides additional discussion of the new proposed standard, the amendments to other PCAOB standards, and comments received on the original proposed standard. Appendix 5 to this release provides a comparison of the key objectives and requirements of the standard to the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants. In developing the new proposed standard, the Board considered the requirements of the relevant standards of the IAASB and the ASB.

**VI. Questions**

The Board requests comments on all aspects of the new proposed standard and is particularly interested in responses to the specific questions below.

1. Are the communication requirements in the new proposed standard appropriately aligned with the performance requirements in the risk assessment standards, where applicable? If not, why?
2. The communication requirements included in the new proposed standard are based on the results of procedures performed during the audit. Are there additional matters that should be

communicated to the audit committee that also are based on existing auditor performance obligations?

3. The auditor is required to have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties is other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.
  - a. Is the requirement in the standard clear?
  - b. As stated, the new proposed standard allows the acknowledgment by the audit committee to be oral. Should the acknowledgement by the audit committee, or its chair on behalf of the audit committee, be required to be in a written form or is oral acknowledgment sufficient?
4. Is the requirement for the auditor to communicate significant unusual transactions to the audit committee appropriate? If not, how should the requirement be modified?
5. Is the requirement appropriate for the auditor to communicate to the audit committee his or her views regarding significant accounting or auditing matters when the auditor is aware that management has consulted with other accountants about such matters and the auditor has identified a concern regarding these matters? If not, how should the requirement be modified?
6. Are the amendments to other PCAOB standards appropriate? If not, why?
7. The Board requests comments regarding the audits of brokers and dealers on the following matters:
  - a. Whether the communication requirements under the Board's interim standard, AU sec. 380, should be applicable to audits of brokers and dealers if audits of brokers and dealers are to be performed under PCAOB standards before the new proposed standard becomes

effective? If so, should it be applicable to audits of all brokers and dealers?

- b. Whether the auditor's communications to audit committees included in the new proposed standard should be applicable to all audits of brokers and dealers?
- c. Are there any communication requirements specific to audits of brokers and dealers that should be added to the new proposed standard? Alternatively, are there any communication requirements contained in the new proposed standard that should not be applicable the audits of brokers and dealers? If so, provide examples and explanations for why the communication requirements for audits of brokers and dealers should be different from other audits covered by the new proposed standard.

## **VII. Effective Date**

The Board anticipates that the proposed transitional amendments to AU sec. 380 included in Appendix 2 would be effective, subject to SEC approval, for the periods that PCAOB standards become applicable to audits of brokers and dealers as designated by the SEC upon adoption of its amendments to Rule 17a-5.

The Board anticipates that the new proposed standard and related amendments will be effective, subject to SEC approval, for audits with fiscal years beginning on or after December 15, 2012.

## **VIII. Opportunity for Public Comment**

The Board is seeking comments on the transitional amendments to AU sec. 380 and the new proposed standard and related amendments. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 030 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on February 29, 2012.

The Board will consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Act.

On the 20th day of December, in the year 2011, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Secretary

## **APPENDIX 1**

### **Proposed Auditing Standard**

#### ***Communications with Audit Committees***

#### ***Supersedes AU sec. 380, Communication With Audit Committees, and AU sec. 310, Appointment of the Independent Auditor***

#### ***Introduction***

1. This standard requires the auditor to communicate certain matters related to the conduct of an audit<sup>1/</sup> to a company's **audit committee**<sup>2/</sup> and to obtain certain information from the audit committee relevant to the audit. "Communicate to," as used in this standard, is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit. This standard also requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee and to record that understanding in an engagement letter.

2. Other Public Company Accounting Oversight Board ("PCAOB") rules and standards identify additional matters to be communicated to a company's audit committee (see Appendix B). Various laws or regulations also require the auditor to communicate other matters to the audit committee.<sup>3/</sup> The communication requirements of this standard do not modify or replace communications to the audit committee required by such other PCAOB rules

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<sup>1/</sup> For purposes of this standard, an audit is either a financial statement audit or an audit of internal control over financial reporting that is integrated with an audit of financial statements.

<sup>2/</sup> Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

<sup>3/</sup> See e.g., Section 10A(k) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 2-07 of Regulation S-X, 17 CFR 210.2-07, and Rule 10A-3 under the Exchange Act, 17 CFR 240.10A-3.

and standards, laws, or regulations. Nothing in this standard precludes the auditor from communicating other matters to the audit committee.

### ***Objectives***

3. The objectives of the auditor are to:
  - a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
  - b. Obtain information from the audit committee relevant to the audit;
  - c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
  - d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

### ***Appointment and Retention***

#### **Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention**

4. The auditor should discuss with the audit committee any significant issues discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

#### **Establish an Understanding of the Terms of the Audit**

5. The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:
  - a. The objective of the audit,
  - b. The responsibilities of the auditor, and
  - c. The responsibilities of management.

6. The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually. The auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company.<sup>4/</sup> If the appropriate party or parties is other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Note: Appendix C describes matters that the auditor should include in the engagement letter about the terms of the audit engagement.

7. If the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept, continue, or perform the engagement.

## **Obtaining Information and Communicating the Audit Strategy**

### **Obtaining Information Relevant to the Audit**

8. The auditor should inquire of the audit committee whether it is aware of matters that might be relevant to the audit,<sup>5/</sup> including, but not limited to, knowledge of violations or possible violations of laws or regulations<sup>6/</sup> and complaints or concerns raised regarding financial reporting matters.<sup>7/</sup>

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<sup>4/</sup> Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

<sup>5/</sup> In addition to this inquiry, paragraph 54 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to inquire of the audit committee, or equivalent, or its chair regarding the audit committee's knowledge of the risks of material misstatement, including fraud risks.

<sup>6/</sup> See AU sec. 317, *Illegal Acts by Clients*, for a description of the auditor's responsibilities when a possible illegal act is detected. For audits of issuers, see also Rule 10A-1 under the Exchange Act, 17 CFR 240.10A-1.

<sup>7/</sup> See Paragraph 56.b.(3) of Auditing Standard No. 12, which requires the auditor to inquire of the audit committee or equivalent, or its chair, regarding whether the audit committee is aware of tips or complaints regarding

## Overall Audit Strategy and Timing of the Audit

9. The auditor should communicate to the audit committee an overview of the overall audit strategy,<sup>8/</sup> including a discussion of the significant risks<sup>9/</sup> identified during the auditor's risk assessment procedures and the timing of the audit.

Note: This overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures.

10. As part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

- a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;<sup>10/</sup>

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the company's financial reporting (including those received through the audit committee's internal whistleblower program) and, if so, the audit committee's responses to such tips and complaints.

<sup>8/</sup> See paragraphs 7-9 of Auditing Standard No. 9, *Audit Planning*, for a description of the auditor's responsibilities for establishing an overall audit strategy.

<sup>9/</sup> Auditing Standard No. 12 requires the auditor to determine whether identified and assessed risks are significant risks. A significant risk is defined as a risk of material misstatement that requires special audit consideration.

<sup>10/</sup> See paragraph 16 of Auditing Standard No. 9 for a description of the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

- b. The extent to which the auditor plans to use the work of the company's internal audit function in an audit of financial statements;<sup>11/</sup>
- c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;<sup>12/</sup>
- d. The names, locations, planned roles, and responsibilities, including the scope of audit procedures,<sup>13/</sup> of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

Note: The term "firms" in the context of this communication includes other auditors, affiliates of the accounting firm (including member firms in the network), and non-affiliated firms that perform audit procedures.

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<sup>11/</sup> See AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which describes the auditor's responsibilities related to the work of internal auditors.

<sup>12/</sup> See generally, paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which describe the auditor's responsibility related to using the work of others in an audit of internal control over financial reporting.

<sup>13/</sup> See paragraphs 8-14 of Auditing Standard No. 9, which discuss the auditor's responsibility for determining the audit strategy, audit plan, and multi-location engagements.

- e. The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors.<sup>14/</sup>

Note: The basis for the auditor's determination that he or she can serve as principal auditor includes situations in which the work is performed by affiliates of the auditor or non-affiliates.

11. The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

## ***Results of the Audit***

### **Accounting Policies, Practices, and Estimates**

12. The auditor should communicate to the audit committee the following matters regarding accounting policies, practices, and estimates:

- a. Significant accounting policies and practices.<sup>15/</sup>
  - (1) Management's initial selection of, and changes in significant accounting policies, or the application of such policies in the current period;
  - (2) The methods management used to account for significant unusual transactions; and

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<sup>14/</sup> AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, discusses the professional judgments the auditor makes in deciding whether he or she may serve as principal auditor.

<sup>15/</sup> See, e.g., Financial Accounting Standards Board, Accounting Standards Codification, Notes to Financial Statements Topic, paragraph 235-10-50-1, which requires the entity to disclose a description of all significant accounting policies as an integral part of the financial statements and paragraph 235-10-50-3, which describes what should be disclosed.

(3) The effect of significant accounting policies on financial statements or disclosures in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

b. **Critical accounting policies and practices.** All critical accounting policies and practices, to be used, including:<sup>16/</sup>

(1) The reasons certain policies and practices are considered critical; and

(2) How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

Note: Critical accounting policies and practices, as defined in Appendix A, are the company's accounting policies and practices that are both most important to the portrayal of the company's financial position and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. Critical accounting policies and practices are tailored to specific events in the current year and the accounting policies and practices that are considered critical might change from year to year.

c. **Critical accounting estimates.**

(1) A description of the process management used to develop critical accounting estimates;

(2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and

(3) Any significant changes management made to the processes used to develop critical accounting estimates or

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<sup>16/</sup> See also Rule 2-07(a)(1) of Regulation S-X, 17 CFR 210.2-07(a)(1).

significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.<sup>17/</sup>

Note: As part of its communications to the audit committee, management might communicate some or all of the matters related to the company's accounting policies, practices, and estimates in paragraph 12. If management communicates any of these matters, the auditor does not need to communicate them at the same level of detail as management, as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor should communicate any omitted or inadequately described matters to the audit committee.

### **Auditor's Evaluation of the Quality of the Company's Financial Reporting**

13. The auditor should communicate to the audit committee the following matters:

- a. Qualitative aspects of significant accounting policies and practices. The results of the auditor's evaluation of and conclusions about the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements;<sup>18/</sup>

Note: The auditor should communicate to the audit committee situations in which the results of his or her

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<sup>17/</sup> See generally, Securities Act Release No. 8350, Section V (December 29, 2003).

<sup>18/</sup> See generally, paragraphs 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*, which describe the auditor's responsibility related to evaluating the qualitative aspects of the company's accounting practices.

evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management.<sup>19/</sup>

- b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make;
- c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates;
- d. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth;<sup>20/</sup>
- e. Matters for which the auditor consulted. Matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are

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<sup>19/</sup> See paragraph 27 of Auditing Standard No. 14.

<sup>20/</sup> See paragraphs 30 and 31 of Auditing Standard No. 14, which describe the auditor's responsibility related to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Other PCAOB standards, such as AU sec. 334, *Related Parties*, and AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describe the auditor's responsibility related to evaluation of specific disclosures in financial statements.

relevant to the audit committee's oversight of the financial reporting process;

- f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting;
- g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor;<sup>21/</sup> and
- h. Material written communications. Other material written communications between the auditor and management.<sup>22/</sup>

### Significant Unusual Transactions

14. The auditor should communicate to the audit committee significant transactions, of which the auditor is aware, that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.<sup>23/</sup> Such communication should include the auditor's understanding of the business rationale for such transactions.<sup>24/</sup>

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<sup>21/</sup> See also Rule 2-07(a)(2) of Regulation S-X, 17 CFR 210.2-07(a)(2).

<sup>22/</sup> See also Rule 2-07(a)(3) of Regulation S-X, 17 CFR 210.2-07(a)(3).

<sup>23/</sup> See paragraph 71.g. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, which describes a significant unusual transaction.

<sup>24/</sup> See paragraph 66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, which describes the auditor's responsibilities related to significant unusual transactions.

## **Other Information in Documents Containing Audited Financial Statements**

15. When other information is presented in documents containing audited financial statements, the auditor should communicate to the audit committee his or her responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.<sup>25/</sup>

## **Management Consultation with Other Accountants**

16. When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation.

## **Going Concern**

17. The auditor should communicate to the audit committee, when applicable, the following matters relating to his or her evaluation of the company's ability to continue as a going concern:<sup>26/</sup>

- a. The conditions and events the auditor identified that, when considered in the aggregate, indicate that there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time;<sup>27/</sup>

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<sup>25/</sup> See generally, AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*. In addition to AU sec. 550, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information*, AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and AU sec. 711, *Filings Under Federal Securities Statutes*.

<sup>26/</sup> See AU sec. 341 for the requirements regarding an auditor's responsibility to evaluate whether there is substantial doubt about a company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

<sup>27/</sup> See AU sec. 341.03a, which discusses the auditor's consideration of factors that indicate there could be substantial doubt about the company's ability to continue as a going concern.

- b. If the auditor's doubt is mitigated, the information that mitigated the auditor's doubt, including, if applicable, a discussion of management's plans.
- c. If the auditor concludes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time:<sup>28/</sup>
  - 1. The effects, if any, on the financial statements and the adequacy of the related disclosure;<sup>29/</sup> and
  - 2. The effects on the auditor's report.<sup>30/</sup>

### **Uncorrected and Corrected Misstatements**

18. The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures<sup>31/</sup> that the auditor presented to management.<sup>32/</sup> The auditor should discuss with the audit committee, or determine that management has adequately discussed with the

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<sup>28/</sup> See AU sec. 341.03b-c, which discuss the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

<sup>29/</sup> See AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

<sup>30/</sup> See AU secs. 341.12-16, which discuss the effects on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

<sup>31/</sup> Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements also include omission and presentation of inaccurate or incomplete disclosures.

<sup>32/</sup> See Section 13(i) of the Exchange Act, which states, in part, that financial statements prepared in accordance with generally accepted accounting principles and filed with the Securities and Exchange Commission "shall reflect all material correcting adjustments that have been identified by a registered public accounting firm ...."

audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors<sup>33/</sup> considered. The auditor also should communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could cause future period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

19. The auditor should communicate to the audit committee those corrected misstatements that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

#### **Departure from the Standard Auditor's Report**

20. The auditor should communicate to the audit committee the following matters related to the auditor's report:

- a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification and the wording of the report; and
- b. When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph and the wording of the explanatory language or paragraph.

#### **Disagreements with Management**

21. The auditor should communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report.

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<sup>33/</sup> Appendix B of Auditing Standard No. 14 discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

Note: Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved prior to the issuance of the auditor's report.

### **Difficulties Encountered in Performing the Audit**

22. The auditor should communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

- a. Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;
- b. An unreasonably brief time within which to complete the audit;
- c. Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;
- d. Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and
- e. Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,<sup>34/</sup> which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

### **Other Matters**

23. The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes complaints or concerns regarding accounting or auditing matters that have come to the

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<sup>34/</sup> See paragraphs .22-.32 of AU sec. 508, *Reports on Audited Financial Statements*, for a discussion of scope limitations.

auditor's attention during the audit and the results of the auditor's procedures regarding such matters.<sup>35/</sup>

### ***Form and Documentation of Communications***

24. The auditor should communicate to the audit committee the matters in this standard, either orally or in writing,<sup>36/</sup> unless otherwise specified in this standard. The auditor must document the communications in the workpapers, whether such communications took place orally or in writing.<sup>37/</sup>

Note: If management communicated matters identified in paragraphs 12 or 18, the auditor must include a copy of or a summary of management's communications provided to the audit committee in the audit documentation.

### ***Timing***

25. All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report.<sup>38/</sup> The appropriate timing of a particular communication to the audit committee

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<sup>35/</sup> Paragraphs .79-.81 of AU sec. 316 and AU sec. 317.17 include specific communication requirements relating to fraud or illegal acts.

<sup>36/</sup> See paragraphs .07-.11 of AU sec. 532, *Restricting the Use of an Auditor's Report*, which apply to certain reports on matters coming to the auditor's attention during the course of the audit.

<sup>37/</sup> Consistent with the requirements of Auditing Standard No. 3, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

<sup>38/</sup> Consistent with Rule 2-07 of Regulation S-X, 17 CFR 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the rules or regulations of the Securities and Exchange Commission.

Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit. The auditor, however, should communicate such matters to the full audit committee prior to the issuance of the auditor's report.

## **APPENDIX A – Definitions**

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Audit committee – a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, those persons designated to oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

A3. Critical accounting estimate – an accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material.

A4. Critical accounting policies and practices – a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

**APPENDIX B – Communications with Audit Committees  
Required by Other PCAOB Rules and Standards**

This appendix identifies other PCAOB rules and standards that require communication of specific matters between the auditor and the audit committee.

- Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, paragraphs 60, 62, and 64
- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraphs 78 - 81, 91, C7, and C14
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 54 and 56
- PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*
- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79-.81
- AU sec. 317, *Illegal Acts by Clients*, paragraphs .08 and .17
- AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, paragraphs 4 - 7 and 9
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .50

- AU sec. 333, *Management Representations*, paragraph .05
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 and .06
- AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, paragraph .09
- AU sec. 711, *Filings Under Federal Securities Statutes*, paragraph .13
- AU sec. 722, *Interim Financial Information*, paragraphs .08, .09, .30, .31, and .33 - .36

**Appendix C – *Matters Included in the Audit Engagement Letter***

C1. The auditor should include the following matters in the engagement letter.<sup>1/</sup> The auditor's description of these matters will vary depending on whether the auditor is engaged in a financial statement audit or in an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

- a. The objective of the audit is:
  1. Integrated audit: The expression of an opinion on both the effectiveness of internal control over financial reporting and the financial statements.
  2. Audit of financial statements: The expression of an opinion on the financial statements.
- b. Auditor's responsibilities:
  1. The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:
    - a. Integrated audit: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance. Also, an integrated audit is not

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<sup>1/</sup> Certain matters should not be included in an engagement letter; e.g., under Section 602.02.f.i. of the Codification of Financial Reporting Policies, indemnification provisions are not permissible for audits of issuers.

designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- b. Audit of financial statements: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

2. An audit includes:

- a. Integrated audit: In fulfillment of the responsibilities noted above, the auditor should communicate:
1. To the audit committee and management: all material weaknesses in internal control over financial reporting identified during the audit in writing.
  2. To the audit committee: all significant deficiencies identified during the audit in writing and inform the audit committee when

the auditor has informed management of all internal control deficiencies.

3. To management: all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others within the company.
  4. To the board of directors: any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, in writing.
- b. Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed.<sup>2/</sup> An audit of financial statements is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating:
1. To the audit committee and management: all significant deficiencies and material weaknesses identified during the audit, in writing.
  2. To the board of directors: if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion, in writing.

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<sup>2/</sup> AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on control deficiencies identified in an audit of financial statements.

- c. Management's responsibilities:
1. Management is responsible for the company's financial statements, including disclosures.
  2. Management is responsible for establishing and maintaining effective internal control over financial reporting.
  3. Management is responsible for identifying and ensuring that the company complies with the laws and regulations applicable to its activities.
  4. Management is responsible for making all financial records and relevant information available to the auditor.
  5. At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.
  6. Management is responsible for adjusting the financial statements to correct material misstatements relating to accounts or disclosures and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

C2. In connection with a review of interim financial information, to confirm and document the understanding, the auditor should either: (a) document in the audit engagement letter the nature and objectives of the engagement to review interim financial information and the responsibilities of management and the auditor or (b) issue a separate engagement letter that addresses such matters.<sup>3/</sup>

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<sup>3/</sup> Paragraphs .08-.09 of AU sec. 722, *Interim Financial Information*, discuss the auditor's responsibilities related to establishing an understanding with the audit committee in connection with a review of the company's interim financial information.

## **APPENDIX 2**

### ***Proposed Amendments to AU sec. 380, Communication With Audit Committees***

#### **Auditing Standard**

##### AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows:

- a. The last sentence of paragraph .01 is replaced with:

The communications required by this section are applicable to the audits of (i) issuers and (ii) brokers and dealers, as those terms are defined in the Sarbanes-Oxley Act of 2002, as amended.<sup>2</sup>

- b. Footnote 2 to paragraph .01 is replaced with:

See Sections 2(a)(7), 110(3) and 110(4) of the Sarbanes-Oxley Act of 2002.

## **APPENDIX 3**

### ***Proposed Amendments to PCAOB Standards***

#### **Auditing Standards**

##### ***Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

- a. The following sentence is added at the end of paragraph 80:  
  
This communication should be made in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.
- b. The following sentence is added after the first sentence of paragraph 81:  
  
The auditor should communicate this information to the audit committee in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.

##### ***Auditing Standard No. 9, Audit Planning***

Auditing Standard No. 9, *Audit Planning*, is amended as follows:

- a. Paragraph 6.c. is replaced with:  
  
Establish an understanding of the terms of the audit engagement with the audit committee in accordance with the proposed auditing standard, *Communications with Audit Committees*.
- b. Footnote 4 to paragraph 6 is deleted.
- c. In footnote 7 to paragraph 9.a., the references to AU sec. 310 and AU sec. 380, *Communication with Audit Committees*, are

replaced with a reference to the proposed auditing standard, *Communications with Audit Committees*.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, is amended as follows:

The note to paragraph 5.d. is deleted

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is superseded.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended is amended as follows:

a. The third sentence of paragraph .79 is replaced with:

Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee in a timely manner and prior to the issuance of the auditor's report.

b. The second sentence of paragraph .81 is replaced with:

Such a communication may be a part of an overall communication to the audit committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the qualitative aspects of the entity's accounting policies and practices (see paragraphs 12 – 13 of proposed auditing standard, *Communications with Audit Committees*). The auditor should communicate these matters to the audit committee in a timely manner and prior to the issuance of the auditor's report.

- c. Within footnote 10 to paragraph .88, the reference to section 380, *Communications With Audit Committees*, is replaced with a reference to the proposed auditing standard, *Communications with Audit Committees*.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Clients" (AU sec. 317, "Illegal Acts by Clients"), as amended, is amended as follows:

- a. The fourth sentence of paragraph .08 is replaced with:

The auditor should make inquiries of management and the audit committee<sup>1</sup> concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations.

- b. Footnote 1 is added to paragraph .08 after the term audit committee:

For this standard, audit committee is defined as a committee (or equivalent body) established by and among the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity; if no such committee exists with respect to the entity, the entire board of directors of the entity. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the entity, those persons designated to oversee the accounting and financial reporting processes of the entity and audits of the financial statements of the entity.

- c. The first sentence of paragraph .17 is replaced with:

The auditor should assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor's report with respect to illegal acts that come to the auditor's attention.

- d. Footnote 1 to paragraph .17 is deleted.

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

Paragraph .50 is replaced with:

Paragraphs 12-13 of the proposed auditing standard, *Communications with Audit Committees*, require the auditor to communicate to the audit committee matters related to critical accounting estimates, which may include fair value measurements.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

The following sentence is added as the last sentence of paragraph .05:

The auditor should provide a copy of the representation letter to the audit committee if management has not already provided the representation letter to the audit committee.

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows:

Paragraph .17A is added, along with the heading preceding this paragraph:

Communications with Audit Committees

Paragraph 17 of the proposed auditing standard, *Communications with Audit Committees*, describes matters an auditor is required to communicate to the audit committee related to the auditor's

evaluation of a company's ability to continue as a going concern for a reasonable period of time.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is superseded.

AU sec. 9380, "Communication With Audit Committees: Auditing Interpretations of Section 380"

AU sec. 9380, "Communication With Audit Committees: Auditing Interpretations of Section 380," is superseded.

AU sec. 532, "Restricting the Use of an Auditor's Report"

SAS No. 87, "Restricting the Use of an Auditor's Report (AU sec. 532, "Restricting the Use of an Auditor's Report"), as amended, is amended as follows:

In the second bullet point of paragraph .07, the reference to Section 380, *Communication With Audit Committees*, is replaced with a reference to the proposed auditing standard, *Communications with Audit Committees*.

AU sec. 550, "Other Information in Documents Containing Audited Financial Statements"

SAS No. 8, "Other Information in Documents Containing Audited Financial Statements" (AU sec. 550, "Other Information in Documents Containing Audited Financial Statements"), as amended, is amended as follows:

- a. The sixth sentence of paragraph .04 is replaced with:

If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement.

- b. The second sentence of paragraph .06 is replaced with:

He should communicate the material misstatement of fact to the client and the audit committee in writing and consider consulting his legal counsel as to further appropriate action in the circumstances.

AU sec. 551, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents"

SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents" (AU sec. 551, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents"), as amended, is amended as follows:

- The second sentence of paragraph .09 is replaced with:

If the client will not agree to revision of the accompanying information, the auditor should communicate the material misstatement to the audit committee and should either modify his report on the accompanying information and describe the misstatement or refuse to include the information in the document.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), as amended, is amended as follows:

- The last sentence of paragraph .13 is replaced with:

In either case, the accountant should communicate the matter to the audit committee and also consider withholding his consent to the use of his report on the audited financial statements in the registration statement.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. The heading preceding paragraph .08, "Establishing an Understanding With the Client" is replaced with the heading, "Establishing an Understanding with the Audit Committee."

- b. Paragraph .08 is replaced with:

The accountant should establish an understanding of the terms of an engagement to review interim financial information with the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee).<sup>6</sup> This understanding includes the objective of the review of interim financial information, the responsibilities of the accountant, and the responsibilities of management. Such an understanding reduces the risk that either the accountant or the audit committee may misinterpret the needs or expectations of the other party. The accountant should record this understanding of the terms of the engagement in an engagement letter and should provide the engagement letter to the audit committee. The accountant should have the engagement letter executed by the appropriate party or parties. If the accountant believes he or she cannot establish an understanding of the terms of an engagement to review interim financial information with the audit committee, the accountant should decline to accept or perform the engagement.

- c. Footnote 6 to paragraph .08 is replaced with:

See paragraph 16 of Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

- d. In the first sentence of paragraph .09, the word "client" is replaced with the words "audit committee."

- e. Paragraph .30 is replaced with:

If management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should communicate these matters to the audit committee as soon as practicable and before the registrant files its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with

paragraph 24 of proposed auditing standard, *Communications with Audit Committees*.

- f. The following sentence is added at the end of paragraph .33:

The accountant should communicate significant deficiencies or material weaknesses of which that the accountant has become aware to the audit committee or those responsible for oversight of the company's financial reporting in a timely manner and prior to the registrant filing its periodic report with the SEC.

- g. Paragraph .34 is replaced with:

When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in the proposed auditing standard, *Communications with Audit Committees*, as they relate to interim financial information, have been identified. If such matters have been identified, the accountant should communicate them to the audit committee in a timely manner and prior to the registrant filing its periodic report with the SEC. For example, the accountant should communicate a description of the process management used to develop the critical accounting estimates; a change in a significant accounting policy affecting the interim financial information; misstatements that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and uncorrected misstatements aggregated by the accountant that management determined to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole.<sup>23</sup> As part of its communications to the audit committee, management might communicate some or all of the matters related to the company's accounting policies, practices, and estimates in paragraph 12 of proposed auditing standard, *Communications with the Audit Committees*. If management communicates any of these matters, the accountant does not need to communicate them at the same level of detail as management, as long as the accountant (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) identified for the audit committee those accounting policies and practices

that the accountant considers critical. The accountant should communicate any omitted or inadequately described matters to the audit committee.

- h. Footnote 23 to paragraph .34 is replaced with:

The schedule of uncorrected misstatements related to accounts and disclosures provided to the audit committee should be same schedule that was included in or attached to the management representation letter that is described in paragraph .24(k) of this section.

- i. The last two sentences of paragraph .35 are replaced with:

Therefore, any communication the accountant may make about the entity's accounting policies, practices, and estimates as applied to its interim financial reporting generally would be limited to the effect of significant events, transactions, and changes in accounting estimates that the accountant considered when conducting the review of interim financial information. Further, interim review procedures do not provide assurance that the accountant will become aware of all matters that might affect the accountant's judgments about the qualitative aspects of the entity's accounting policies and practices that would be identified as a result of an audit.

- j. Paragraph .36 is replaced with:

If the accountant has identified matters to be communicated to the audit committee, the accountant should communicate such matters to the audit committee, or at least its chair, in a timely manner and before the registrant files its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 24 of proposed auditing standard, *Communications with Audit Committees*.

**Quality Control Standards**

**QC sec. 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice"**

QC sec. 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice," as amended, is amended as follows:

In paragraph .16:

- In the first sentence, the word "client" is replaced with the words "audit committee."
- The last sentence is deleted.

## **APPENDIX 4**

### ***Additional Discussion of the New Proposed Standard, Amendments to PCAOB Standards, and Comments on the Original Proposed Standard***

This appendix discusses *Communications with Audit Committees* (the "new proposed standard"), presented in Appendix 1, and the related proposed amendments to PCAOB standards in Appendix 3. In particular, this appendix provides additional background information for certain requirements in the new proposed standard and related amendments.

On March 29, 2010, the Board issued a proposed standard (the "original proposed standard") on communications with audit committees,<sup>1/</sup> reopened the comment period on September 7, 2010, and held a public roundtable on September 21, 2010. This appendix discusses the Board's responses to comments received on the original proposed standard, including comments at the roundtable ("commenters"), as well as the basis for the Board's preliminary determinations regarding certain requirements.

#### **I. Definition of Audit Committee**

The original proposed standard incorporated the definition of "audit committee" from section 2(a)(3) of the Sarbanes-Oxley Act of 2002 (the "Act"), which states that an audit committee is a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; if no such committee exists with respect to an issuer, the entire board of directors of the issuer.<sup>2/</sup> The new proposed standard includes a modified version of that definition as discussed below.

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>3/</sup> granted the Board oversight of the audits of brokers and

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<sup>1/</sup> PCAOB Release No. 2010-001, *Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards* (March 29, 2010).

<sup>2/</sup> Section 2(a)(3) of the Act.

<sup>3/</sup> Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

dealers registered with the U.S. Securities and Exchange Commission ("SEC"). On June 15, 2011, the SEC proposed<sup>4/</sup> to amend its rules to require, among other things, that audits of brokers' and dealers' financial statements and examinations and reviews of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB. The Board recognizes, however, that some brokers and dealers may have governance structures that do not include boards of directors or audit committees. For the auditor communication requirements to apply to the audits of brokers and dealers or other nonissuers, the definition of audit committee has been modified to add " for the audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to a company, those persons designated to oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company."

The revised definition of "audit committee" would require the auditor to identify the bodies or persons that oversee the company's accounting, auditing and financial reporting processes to find the appropriate recipient of the communications under the standard.<sup>5/</sup> For issuers, the proposed definition is the same as the definition included in the Act.<sup>6/</sup> For nonissuers, the proposed definition contains three categories of bodies or persons, with the first two being the same the definition for an issuer and the third category covering situations in which the company does not have a board of directors or equivalent body, such as certain non-public brokers and dealers.

The term "audit committee," for the purposes of the new proposed standard, therefore, would be the committee (or equivalent body) established by the board of directors to oversee the accounting and financial reporting processes of the company and audits of the entities of the financial statements.

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<sup>4/</sup> See Broker-Dealer Reports, Exchange Act Release No. 64676.

<sup>5/</sup> The Board's proposed definition is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, or an entity's governing documents regarding the establishment, approval, or ratification of boards of directors or audit committees, or the delegation of responsibilities of such a committee or board.

<sup>6/</sup> Section 2(a)(3) of the Act.

If no such committee exists then, consistent with the Act, the term "audit committee" would refer to the entire board of directors. For nonissuers, if there is no audit committee or board (or equivalent body), then the term "audit committee" in the new proposed standard would refer to those designated to oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company. The Board is proposing to include the parenthetical phrase "or equivalent body" after the term "board of directors" to clarify that entities with bodies performing a function similar to that of a corporate board of directors would fit within this category. There would be no need for a formal "designation" of the persons in the third category. The word "designated" is meant to imply that senior persons with decision making authority and responsibility in such circumstances should be the recipients of the auditor communications.<sup>7/</sup>

## **II. Objectives**

The original proposed standard stated that the objectives of the auditor are (a) communicating to the audit committee the responsibilities of the auditor in relation to the audit and establishing a mutual understanding of the terms of the audit engagement with the audit committee; (b) communicating to the audit committee an overview of the audit strategy and timing of the audit; (c) providing the audit committee with timely observations arising from the audit that are significant and relevant to the financial reporting process; and (d) evaluating the adequacy of the two-way communications between the auditor and the audit committee to support the objectives of the audit.

Most commenters indicated that the objectives stated in the original proposed standard were appropriate. Some commenters indicated that it is important for the auditor to obtain information that is relevant to the audit from the audit committee and that the objectives should emphasize the importance of receiving such information. The Board agrees and has added this as another objective of the auditor in the new proposed standard. Additionally, in response to commenter's concerns, the auditor's evaluation of the adequacy of the two-way communications between the auditor and the audit committee was

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<sup>7/</sup> For example, in an owner-managed entity, the designated person would be the owner. For a limited partnership, the designated person may be the managing or general partner responsible for preparation of the financial statements.

removed from the objectives to be consistent with the removal of the related requirement in the standard.<sup>8/</sup>

Several commenters indicated that the objectives listed in the original proposed standard only summarize the requirements of the original proposed standard. These commenters suggested that the objectives should be revised to assist the auditor in understanding the requirements of the original proposed standard, not just repeating them. The objectives of the standard are intended to highlight the overall context for the requirements in the standard. Accordingly, the objectives of the new proposed standard were revised to reflect the revisions made to the original proposed standard.

### **III. Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention**

The original proposed standard retained the requirement in AU sec. 380, *Communication With Audit Committees*, for the auditor to discuss with the audit committee any significant issues that were discussed with management in connection with the initial appointment or retention of the auditor, including any discussions regarding the application of accounting principles and auditing standards.<sup>9/</sup> Several commenters indicated that it was not necessary to retain this requirement since auditors of listed companies are hired by the audit committee subsequent to the Act.<sup>10/</sup> The requirement in AU sec. 380 was written prior to the Act. The Board retained this requirement because the audit committee might ask management for its views concerning the appointment or retention of the auditor based on the interaction between the auditor and

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<sup>8/</sup> See further discussion of the removal of this requirement in section XX, Adequacy of the Two-Way Communication Process, of this appendix.

<sup>9/</sup> Paragraph 15 of AU sec. 380.

<sup>10/</sup> The Act directed the SEC to promulgate rules that require the audit committee of issuers with securities listed on a national securities exchange or in an automated inter-dealer quotation system through a national securities association be directly responsible for the appointment, compensation, and oversight of the work of the auditors (see Section 301 of the Act).

management. Additionally, management's views might be influenced by the auditor's evaluations and conclusions regarding the application of accounting principles or auditing standards.

One commenter suggested that the communication should be limited to significant discussions regarding the application of accounting principles or auditing standards. Accordingly, the wording in the original proposed standard was revised from "any discussions regarding the application of accounting principles and auditing standards" to "significant discussions" in order to narrow the scope of the communications to only the most important matters that might influence the appointment or retention of the auditor.

#### **IV. Establish an Understanding of the Terms of the Audit**

The original proposed standard included a specific requirement for the auditor to establish a mutual understanding of the terms of the audit engagement with the audit committee. This requirement was included to ensure that the auditor and the audit committee understand the objectives of the audit, the responsibilities of the auditor, and the responsibilities of management.

Some commenters indicated that in addition to the responsibilities of the auditor and management, the engagement letter also should include the responsibilities of the audit committee related to the audit. Other commenters indicated that the audit committee's responsibilities are already set out in the audit committee charter and that those responsibilities should be left to the governance process, subject to the rules of the SEC or the stock exchange governance rules. The Board considered this suggestion and did not change the standard to include the responsibilities of the audit committee, as those responsibilities are governed by other rules.

Several commenters noted that the original proposed standard did not specifically state that the engagement letter should be provided to the audit committee annually. Under the timing section of the original proposed standard, all communications required by the original proposed standard should be made annually, including the engagement letter. However, to clarify the requirement, the new proposed standard was revised to specifically require that the engagement letter be provided to the audit committee annually.

Another commenter indicated that it was unclear whether the Board's intent was for the engagement letter to be prepared annually or provided

annually to the audit committee. In establishing this requirement, it is not the Board's intent to have the auditor prepare a new engagement letter every year if there is no change from the prior year. Rather the Board's intention is for the auditor to confirm his or her understanding of the terms of the audit engagement with the audit committee by providing them with the engagement letter annually.

The original proposed standard required the auditor to have the engagement letter executed by the appropriate party or parties.<sup>11/</sup> The new proposed standard adds that if the appropriate party or parties is other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement. Obtaining the audit committee members' signatures, or its chair's signature on behalf of the audit committee, or the audit committee's acknowledgement regarding the terms of the audit engagement reduces the risk that either the auditor or the audit committee might misinterpret the expectations of the other party.

The acknowledgement by the audit committee may be provided orally to the auditor or may be demonstrated through other means, such as the minutes of the audit committee meeting. An acknowledgement by the audit committee or the signature of the audit committee members, or the signature of its chair on behalf of the audit committee, on the engagement letter is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, or the company's governing documents, regarding the authority or lack of authority, of the audit committee to enter into any contract or agreement with the auditor.

Other commenters suggested that the auditor should highlight the changes in the engagement letter from the prior year. The Board did not consider it necessary to establish a requirement for the auditor to highlight changes in the engagement letter; however, auditors might wish to do so and the audit committees might make such a request of the auditors.

Appendix C of the original proposed standard described matters that should be included in an engagement letter, including the objective of the audit

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<sup>11/</sup> Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

and the responsibilities of the auditor and management. Some commenters suggested adding additional matters to be communicated in the audit engagement letter, such as the audit fees and the timing of the audit. The Board considered the suggested changes to Appendix C and determined that it would be impractical for the standard to list all matters that could be included in an engagement letter. However, other matters could be included, as agreed upon by the auditor and the audit committee, so long as those matters are not in violation of other standards or rules, e.g., independence requirements.

#### **V. Obtaining Information Related to the Audit**

The original proposed standard included a requirement for the auditor to inquire of the audit committee about whether it is aware of matters that may be related to the audit, including complaints or concerns raised regarding accounting or auditing matters. This inquiry would complement the requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks, in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.<sup>12/</sup> This requirement was included in the original proposed standard because, in addition to the inquiries required as part of the risk assessment procedures, audit committees may be aware of other matters that might be relevant to the auditor in planning and performing audit procedures (e.g., strategic decisions that might significantly affect the nature, timing, and extent of audit procedures).

Additionally, complaints or concerns may come to the audit committee's attention through the audit committee's process for reporting ethics violations or concerns related to financial reporting<sup>13/</sup> that are relevant to the audit. It is important that the auditor's discussions of these matters with the audit committee be robust and substantive. The new proposed standard does not provide specific timing for these inquiries to be made; however, information provided by the audit committee could require the auditor to adjust planned audit procedures. Therefore, performing these inquiries early in the audit

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<sup>12/</sup> See paragraph 54 of Auditing Standard No. 12.

<sup>13/</sup> See *generally*, Section 10A(m)(4) of the Exchange Act, and Rule 10A-3(b)(3) of the Exchange Act 17 CFR 240.10A-3(b)(3).

process would enable the auditor to incorporate the information received from the audit committee into the audit strategy.

Several commenters suggested that the standard should emphasize that inquiries of the audit committee should not be limited to matters that arise from complaints or concerns regarding accounting or auditing matters. Those commenters suggested that the inquiries of the audit committee should be expanded to include other matters, such as noncompliance with laws and regulations, knowledge of illegal acts or potential illegal acts, complaints or concerns during a client's enterprise risk management assessment, and issues brought forward that may impact internal controls. The requirement in the original proposed standard was not meant to be limited only to matters that arise from complaints or concerns raised regarding accounting or auditing matters. Therefore, the new proposed standard was revised to require the auditor to inquire of the audit committee about matters that might be relevant to the audit, including, but not limited to, knowledge of violations or possible violations of laws or regulations and complaints or concerns raised regarding financial reporting matters.

One commenter suggested that the responses from the audit committee should be documented in an audit committee representation letter addressed to the auditor. The commenter indicated that the letter would provide written confirmation of the audit committee's awareness of certain matters relating to the audit, which is similar to the management representation letter. AU sec. 333, *Management Representations*, requires the auditor to obtain written representation from management to complement other auditing procedures, ordinarily to confirm representations explicitly or implicitly given to the auditor. Typically, written representations are obtained from those responsible for the preparation of the financial statements. Due to its responsibility for the preparation of the financial statements and its responsibilities for the company's operations, management would be expected to have sufficient knowledge of the preparation of the financial statements in order to provide written representation. The audit committee's responsibilities are typically different from management's responsibilities for the preparation of the financial statements and the conduct of the company's operations. Therefore, it was not considered necessary to include a requirement to obtain representation from the audit committee that is similar to that obtained from management. However, neither the new proposed standard nor PCAOB rules preclude an auditor from requesting a representation letter from the audit committee. Additionally, AU

sec. 333 currently states that, in certain circumstances, the auditor may want to obtain written representations from other individuals (such as to verify completeness of meetings of stockholders, directors, and committees).

One commenter suggested that when the audit committee is not made up of entirely independent directors, but primarily includes management directors, the auditor should employ a greater degree of skepticism than would be applied if the audit committee consisted entirely of independent directors. Auditing standards require the auditor to exercise professional skepticism regarding gathering and evaluating audit evidence.<sup>14/</sup> Because the auditor is required to exercise professional skepticism in the performance of an audit, creating different degrees of skepticism in this standard based on the make-up of the audit committee was not deemed necessary or appropriate. Additionally, Auditing Standard No. 12 requires that, when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, the auditor should take into account the fact that management is often in the best position to commit fraud and the auditor should obtain evidence to address inconsistencies in responses to inquiries.<sup>15/</sup> Therefore, the new proposed standard was not revised to discuss situations in which the audit committee consists primarily of management directors.

## **VI. Overall Audit Strategy and Timing of the Audit**

The original proposed standard included a requirement for the auditor to communicate to the audit committee an overview of the audit strategy, including a discussion of the significant risks identified by the auditor,<sup>16/</sup> and the timing of the audit. Under this requirement the auditor communicates to the audit committee the results of audit procedures performed in accordance with

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<sup>14/</sup> See paragraph .07 of AU sec. 230, *Due Professional Care in the Performance of Work*, and paragraph 7 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>15/</sup> See paragraph 58 of Auditing Standard No. 12.

<sup>16/</sup> See paragraph A5 of Auditing Standard No. 12, which defines significant risk.

other PCAOB standards, such as Auditing Standard No. 9, *Audit Planning*, which requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

One commenter suggested that management should lead the discussion regarding significant risks, with the auditor's involvement. As part of the auditor's risk assessment process, the auditor is required to identify and assess the risk of material misstatement, including significant risks.<sup>17/</sup> A significant risk is a risk of material misstatement that requires special audit consideration.<sup>18/</sup> These risks may be similar to risks that management identifies, but the auditor's communication to the audit committee is specific to the significant risks the auditor has identified in accordance with Auditing Standard No. 12. Therefore, the new proposed standard was not revised.

Several commenters suggested that the communication of the audit strategy and significant risks should be made as early as possible in the audit process. The original proposed standard required that the communications be made in a timely manner, which depends on factors such as the significance of the matter and corrective or follow-up action needed. Therefore, further specification in the new proposed standard regarding timing was not considered necessary because facts and circumstances may vary from audit to audit. However, early communication of these matters might enable the audit committee to understand the auditor's views regarding risk and thereby provide an opportunity for the audit committee to communicate insights regarding additional risks that the auditor did not identify and allow the auditor to incorporate the additional risks in a timely manner into the audit strategy.

The original proposed standard also included a requirement for the auditor to communicate, in a timely manner, significant changes to the planned audit strategy or the significant risks initially identified. One commenter suggested that the statement "due to the results of audit procedures or in response to external factors," which was included in the release accompanying

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<sup>17/</sup> See paragraphs 59, 70, and 71 of the Auditing Standard No. 12.

<sup>18/</sup> The factors the auditor should evaluate in determining which risks are significant risks are included in paragraph 71 of Auditing Standard No. 12.

the original proposed standard, also should be included in the standard. This additional language was not added to the new proposed standard as there could be other circumstances that might require changes to the planned audit strategy or significant risks, such as changes in the company's performance or subsequent events. This communication will inform the audit committee of the matters that might impact the audit procedures or timing of the audit procedures to be performed.

#### **A. Specialized Skill or Knowledge**

The original proposed standard included a requirement for the auditor to communicate the auditor's determination of whether persons with specialized skill or knowledge are needed to apply the planned audit procedures or evaluate the audit results.<sup>19/</sup> Several commenters suggested that the communication about persons with specialized skill or knowledge should focus on specialists whose work merits the audit committee's attention based on the nature of the specialist's involvement and the relative complexity and significance of the financial reporting area for which the specialist is involved. Commenters also suggested that the communication should not include the firm's tax and information technology specialists. The requirement in the new proposed standard is designed to communicate the determination the auditor is required to make as part of developing the audit strategy in Auditing Standard No. 9. In response to commenters, the new proposed standard was revised to limit the communication to specialized skill or knowledge needed related to significant risks.

Other commenters indicated that the proposed standard was unclear regarding whether the Board intended this requirement to apply to all specialists or only to those specialists outside the audit firm. Many audit firms have employees with specialized skill or knowledge that the engagement team can utilize. However, other firms might not have such in-house expertise. The focus of this requirement is on the communication about the need for specialized skill or knowledge, regardless of whether the specialist is from

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<sup>19/</sup> See paragraph 16 of Auditing Standard No. 9 for the description of the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

within the firm or outside the firm. Therefore, the language from the original proposed standard was retained.

## **B. Internal Audit**

The original proposed standard required the auditor to communicate to the audit committee the auditor's consideration of, and planned use of, the company's internal audit function to perform audit procedures in an audit of financial statements. In addition, the original proposed standard required that the auditor communicate the extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting.

One commenter suggested that the original proposed standard implied that the auditor can use the internal audit staff without limit and without regard to other mandated responsibilities. Therefore, the commenter suggested that the standard should focus on the auditor's use of the internal auditor's work, including a cooperative and coordinated relationship, and that the audit strategy should include the approach to risk assessment and evaluation of the control environment. Auditing Standard No. 9 requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan, including the nature, timing, and extent of resources necessary to perform the engagement. Other standards, including AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, provide additional requirements and impose limits on the use of internal audit staff. The requirement in the new proposed standard is to communicate to the audit committee the extent to which the auditor plans to use the work of the company's internal audit function, as determined in the audit plan. That communication requirement does not impact the limitations imposed by other standards on the auditor's use of the internal audit function.

## **C. Firms or Other Accountants Performing Audit Procedures**

The original proposed standard required the auditor to communicate to the audit committee the roles, responsibilities, and locations of firms

participating in the audit. In planning and performing an audit, an auditor determines the locations or business units at which to perform audit procedures. Auditors might anticipate using affiliated or network firms, non-affiliated firms or other persons to perform audit procedures at individual locations, business units or specific audit areas.

Several commenters suggested that the standard should clarify which firms are covered by this requirement. The new proposed standard was revised to require that the auditor communicate the names, locations, planned roles, and responsibilities, including the scope of audit procedures, of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period. Additionally, the standard includes a note to clarify that this communication includes other auditors, affiliates of the accounting firm (including member firms in the network), and non-affiliated firms that perform audit procedures. The requirement for the auditor to communicate the names, locations, planned roles, and responsibilities of such firms and other accountants would provide information to the audit committee regarding the parties involved in the audit. This requirement also might facilitate a discussion of how the work of other parties would affect the audit.

Another commenter suggested that the requirement should not include the locations or business units for which only a statutory audit is performed. The communication requirement in the new proposed standard relates to the audit of the consolidated financial statements, which may or may not include reliance on audit procedures performed as part of statutory audits. The Board's intention is for the auditor to communicate to the audit committee the roles and responsibilities of firms whose work the auditor plans to use in the audit to form the basis for his or her opinion on the consolidated financial statements.

One commenter suggested that the proposed standard should require the auditor to disclose the percentage of audit work performed by each firm based on assets, revenues, or other criteria. The communication requirement regarding the work performed by other firms is related to the names, locations, planned roles, and responsibilities, but does not include a requirement for the auditor to communicate the percentage of audit work performed by each firm. It should be noted however that the Board has proposed amendments to AU

sec. 508, *Reports on Audited Financial Statements*,<sup>20/</sup> that would require the auditor to disclose in the auditor's report the names, locations, and percentage of hours attributable to the audits or audit procedures performed by the other participants in the audit in relation to the total audit hours in the most recent period's audit. If, at the conclusion of that rulemaking project, the Board adopts the proposed disclosure requirements for the auditor's report, the Board may consider, in a future rulemaking project, amending the *Communications with Audit Committees* standard to require the auditor to communicate these matters to the audit committee.

One commenter indicated that communication regarding affiliated or network firms participating in the audit might put local, regional, and national firms at a disadvantage to large international firms due to their lack of singular branded audit name recognition. The requirement to communicate other participants in the audit was retained, because the audit committee should be aware of other independent public accounting firms or other persons involved in the audit, whether the audit is performed by affiliates of the auditor or non-affiliates.

#### **D. Principal Auditor**

The original proposed standard required the auditor to communicate the basis for the auditor's determination that he or she can serve as principal auditor. Several commenters noted that, in many circumstances, this determination does not require significant consideration given the relative insignificance of the involvement of other auditors. These commenters suggested that this issue is unlikely to merit the attention of the audit committee. Therefore, the requirement related to serving as principal auditor was revised to require the auditor to communicate to the audit committee the basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit would be performed by other auditors, whether such work is performed by affiliates of the auditor or non-affiliates.

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<sup>20/</sup> See amendments to AU sec. 508 proposed by PCAOB Release No. 2011-007, *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2* (October 11, 2011).

**E. Other Matters Related to the Overall Audit Strategy and Timing of the Audit**

The original proposed standard noted that the overview of the audit strategy is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures. Communicating certain details might reduce the effectiveness of those audit procedures.

Several commenters suggested that the auditing standard should identify certain matters that should not be communicated to the audit committee, such as materiality levels, tolerable error, amounts below which audit differences are not accumulated, and the extent and detailed scope of tests and procedures. The original proposed standard did not require the communication of these matters, rather, it left the matters to be communicated and the level of detail to the discretion of the auditor. However, as noted in the original proposed standard, the information communicated should not provide specific details that would compromise the effectiveness of the audit procedures. Therefore, the new proposed standard was not revised.

Several commenters suggested that audit committee members are interested in an assessment of the "tone at the top" of the organization, including financial management. However, these same commenters indicated that the Board should not make this assessment a requirement in the standard. In accordance with other PCAOB standards, the auditor is required to evaluate the control environment of the company<sup>21/</sup> including:

- Whether management philosophy and operating style promote effective internal control over financial reporting; and
- Whether sound integrity and ethical values, particularly of top management, are developed and understood.

If, based on this evaluation, the auditor determines that a significant deficiency or material weakness exists, the auditor must communicate these

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<sup>21/</sup> See paragraph 25 of Auditing Standard No. 5 and paragraph 23 of Auditing Standard No. 12.

matters to the audit committee.<sup>22/</sup> Additionally, if the auditor determines that a significant risk exists related to "tone at the top" at the company, the new proposed standard requires the auditor to communicate to the audit committee significant risks identified. Therefore, it was not necessary to revise the new proposed standard to require the auditor to communicate an assessment of "tone at the top." In any event, the new proposed standard does not preclude an auditor from responding to the audit committee's request for the auditor to comment on "tone at the top."

## **VII. Accounting Policies, Practices, and Estimates**

The original proposed standard required the auditor to communicate certain matters related to the company's accounting policies, practices, and estimates.

### **A. Accounting Policies and Practices**

The original proposed standard required the communication to the audit committee of the company's significant accounting policies and practices and also the critical accounting policies and practices. The original proposed standard defined critical accounting policies and practices using the same definition that the SEC uses.

Some commenters indicated that the standard should define both significant and critical accounting policies and practices, while other commenters suggested that adding examples to differentiate between significant accounting policies and practices and critical accounting policies and practices might be helpful. Another commenter indicated that the original proposed standard is consistent with current PCAOB and SEC requirements as they relate to the difference between significant accounting policies and practices and critical accounting policies and practices.

The Board has retained both the term "significant accounting policies and practices" and "critical accounting policies and practices." The term "significant accounting policies and practices" is consistent with AU sec. 380 and understood in practice and therefore has not been separately defined. The

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<sup>22/</sup> See paragraph 4 of AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, and paragraph 78 and 80 of Auditing Standard No. 5.

Financial Accounting Standards Board's ("FASB"), Accounting Standards Codification ("ASC") and the International Accounting Standards Board ("IASB"), require the company to disclose a description of all significant accounting policies as an integral part of the financial statements.<sup>23/</sup> For example, the FASB ASC recognizes that an entity's description of its significant accounting policies is an integral part of its financial statements.<sup>24/</sup>

The term "critical accounting policies and practices" is defined by the SEC as a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.<sup>25/</sup> The selection of significant accounting policies and practices involves a broader range of transactions and events over time, while the selection of critical accounting policies and practices is tailored to specific events in the current year. Therefore, critical accounting policies and practices might essentially be viewed as a subset of significant accounting policies and practices.

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<sup>23/</sup> See FASB, ASC, Notes to Financial Statements Topic, section 235-10-50. As part of this disclosure, the entity is required to disclose accounting policies and to describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. Additionally, see paragraph 117 of International Accounting Standard 1, *Presentation of Financial Statements*, which requires the entity to disclose the summary of significant accounting policies, including measurement basis used in preparing the financial statements and other accounting policies that are relevant to understanding the financial statements.

<sup>24/</sup> See FASB ASC paragraph 235-10-50-1 through ASC paragraph 235-10-50-6.

<sup>25/</sup> See Securities Act of 1933 ("Securities Act"), *Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 8183 (March 27, 2003).

## 1. Significant Accounting Policies and Practices

The new proposed standard generally retains the requirements from AU sec. 380 related to communication of the company's significant accounting policies and practices, including:

- Management's initial selection of, and changes in significant accounting policies, or the application of such policies in the current period;
- The methods management used to account for significant unusual transactions; and
- The effect of significant accounting policies on financial statements or disclosures in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

The original proposed standard included a requirement for the auditor to communicate to the audit committee the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. The word "emerging" was removed from the new proposed standard as there might be areas for which there is a lack of authoritative guidance or consensus, or diversity in practice that are no longer emerging that warrant the attention of the audit committee.

The new proposed standard requires the auditor to communicate significant accounting policies and practices to the audit committee, whereas AU sec. 380 required the auditor only to determine that the audit committee was "informed." This change in wording is intended to promote the auditor's active participation in the communication of the significant accounting policies and practices, rather than just the determination that the audit committee was informed.

## 2. Critical Accounting Policies and Practices

The original proposed standard required the auditor to communicate how current and anticipated future events generally may affect the determination by the auditor of whether certain policies and practices are

considered critical. Some commenters indicated that the Board should clarify whether this requirement is intended for the auditor to communicate matters in addition to the existing requirements in AU sec. 380 and the SEC's Rule 2-07 of Regulation S-X.<sup>26/</sup> Some commenters recommended deleting the requirement for communicating anticipated future events since the auditor cannot predict the future.

The new proposed standard retains the SEC requirements from the original proposed standard regarding communication of anticipated future events related to critical accounting policies and practices. The new proposed standard also notes that critical accounting policies and practices are tailored to specific events in the current year and that the accounting policies and practices that are considered critical might change from year to year. For example, a significant merger or acquisition may result in the related accounting policy being considered critical in the year in which the related transaction occurs, but not in subsequent years.

## **B. Critical Accounting Estimates**

The original proposed standard retained existing requirements regarding accounting estimates from AU sec. 380.08. The original proposed standard also included the following new requirements for the auditor to communicate:

- a. How management subsequently monitors critical accounting estimates;
- b. Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;
- c. Any significant changes to assumptions or processes made by management to the critical accounting estimates in the year under audit, a description of the reasons for the changes, the effects on the financial statements, and the information that supports or challenges such changes; and
- d. When critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and

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<sup>26/</sup> 17 CFR 210.2-07, Section 10A(k) of the Exchange Act also requires the auditor to report this information to the audit committee.

how various selections within the range would affect the company's financial statements.

As the term "critical accounting estimate" implies, the communication is not designed to encompass a long list of accounting estimates resulting from the application of accounting policies that cover a substantial number of line items in the company's financial statements. Rather, the original proposed standard defined the term "critical accounting estimate" as an accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and (b) the impact of the estimate on financial condition or operating performance is material. This definition of critical accounting estimate is the same definition the SEC uses in connection with management's discussion and analysis of the company's financial condition and results of operations.<sup>27/</sup> The term critical accounting estimate is used to help focus the communication to the audit committee on those estimates, including certain fair value estimates, that might be subject to a higher risk of material misstatement. The definition of a critical accounting estimate is intended to include those estimates deemed "particularly sensitive" under AU sec. 380.<sup>28/</sup>

Some commenters supported the communication requirements regarding critical accounting estimates as presented in the original proposed standard. Other commenters expressed concern regarding the amount of communication requirements in the original proposed standard related to critical accounting estimates. One commenter indicated that the required communications for critical accounting estimates were overly prescriptive and would be challenging to implement. Additionally, some commenters suggested that how management subsequently monitors critical accounting estimates should be solely management's responsibility and not the responsibility of the

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<sup>27/</sup> *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 8350 (December 19, 2003).

<sup>28/</sup> See AU sec. 380.08, which states in part, "certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments."

auditor. Some commenters also suggested that, instead of requiring the auditor to determine how various selections within a range would affect the company's financial statements, the auditor should supplement management's communications by providing the audit committee with the auditor's views regarding the reasonableness of management's critical accounting estimates as well as the auditor's concerns regarding management bias, if any. Some commenters indicated that the standard should provide additional guidance that allows for the auditor's consideration of when communications regarding critical accounting estimates merit the attention of the audit committee.

In response to comments received, the original proposed requirements to communicate how management subsequently monitors critical accounting estimates and to communicate when critical accounting estimates involve a range and how various selections within the range would affect the company's financial statements were removed from the new proposed standard.

Although these requirements were removed from the new proposed standard, the Board notes that the SEC has stated that management should disclose in management's discussion and analysis ("MD&A") section of the Form 10-K the company's critical accounting estimates.<sup>29/</sup> According to the related SEC release, management's discussion should present, among other matters, the company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time and analyze an estimate's specific sensitivity to change based on other outcomes that are reasonably likely to occur and would have a material effect.<sup>30/</sup> AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires the auditor to read the other information in documents containing audited financial statements and consider whether the information, or the manner of its presentation, is materially inconsistent with information in the financial statements or is a material misstatement of fact.<sup>31/</sup>

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<sup>29/</sup> *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 8350 (December 19, 2003).

<sup>30/</sup> Ibid.

<sup>31/</sup> AU secs. 550.04-.05.

The new proposed standard includes a requirement for the auditor to communicate to the audit committee the results of such procedures (see Section X. Other Information in Documents Containing Audited Financial Statements for further discussion).

### **C. Consideration of Communications Made by Management**

The original proposed standard retained the substance of the communication requirements in AU sec. 380 regarding accounting policies, practices, and estimates. Similar to AU sec. 380, the original proposed standard acknowledged that management also may be communicating certain matters related to the financial reporting process to the audit committee. The original proposed standard required the auditor to communicate certain matters but also provided that, if management communicated the matters to the audit committee, the auditor should determine whether all the matters were adequately described. If not, the original proposed standard required the auditor to communicate any omitted or inadequately described matters to the audit committee.

The original proposed standard included a requirement that was consistent with Section 10A(k) of the Exchange Act, which requires auditors of issuers and certain registered investment companies to report all critical accounting policies and practices<sup>32/</sup> to the issuer's audit committee. Some commenters suggested that management, rather than the auditor, should communicate to the audit committee the company's critical accounting policies and practices. One commenter indicated that, despite the statutory requirement in the Exchange Act, the communication of critical accounting estimates is the responsibility of management. The commenter also indicated that the auditor should supplement management's communications by providing his or her views about the quality and reasonableness of management's selection, application, and disclosure of critical accounting estimates, as well as his or her concerns regarding potential bias in management's estimates. Some commenters indicated that the requirements for auditors to communicate the accounting policies, practices, and estimates would be duplicative of management's communication. Another commenter, however, indicated that the auditor should communicate these matters to the audit committee even if management has already described these matters to the audit committee.

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<sup>32/</sup> See also Rule 2-07 of Regulation S-X, 17 CFR 210.2-07.

The Board recognizes that management as well as the auditor might discuss accounting policies, practices, and estimates with the audit committee and that it would not be cost-effective or practical for the audit committee to listen to essentially the same presentation twice. Therefore, the new proposed standard indicates that the auditor communication requirement under the standard would be met if the auditor (1) participates<sup>33/</sup> in management's discussion with the audit committee about accounting policies, practices, and estimates; (2) affirmatively confirms to the audit committee that management has adequately discussed the company's accounting policies, practices, and estimates in the meeting; and (3) identifies for the audit committee those accounting policies and practices that the auditor considers critical.

In situations in which management makes those communications to the audit committee, in order to satisfy the communication requirement in the new proposed standard, the auditor would be required to participate during discussions between management and the audit committee regarding accounting policies, practices, and estimates, which may include discussions of the importance of critical accounting policies, practices or estimates, or the difficult, subjective, or complex nature of the judgment involved in the selection or application of each accounting policy, practice, or estimate. The requirements for the auditor to identify the accounting policies and practices that the auditor considers critical to the portrayal of the company's financial condition and results and affirmatively confirm that management has adequately communicated each of the accounting policies, practices, and estimates to the audit committee in the meeting in which the auditor participated would be deemed to satisfy the requirement for the auditor to report all critical accounting policies and practices to the audit committee, without the need for the auditor to repeat management's presentation on the same topic.

Conversely, if the auditor (1) did not participate in management's meeting with the audit committee in which communication regarding accounting policies, practices, and estimates occurred, (2) did not affirmatively confirm that accounting policies, practices, and estimates had been discussed adequately by management, or (3) did not identify those accounting policies and practices that the auditor considers critical, then the auditor would be required to communicate to the audit committee the matters described in paragraph 12 of

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<sup>33/</sup> The auditor's participation in management's discussion with the audit committee could be satisfied in-person or via audio or video conference.

the new proposed standard, regardless of any management communication regarding those accounting policies, practices, and estimates.

### **VIII. Auditor's Evaluation of the Quality of the Company's Financial Reporting**

The original proposed standard required the auditor to communicate certain matters to the audit committee regarding the auditor's views of the audit and the financial statements as described below.

#### **A. Qualitative Aspects of Significant Accounting Policies and Practices**

The original proposed standard required the auditor to communicate to the audit committee situations in which the auditor determines that potential bias exists in management's accounting estimates.<sup>34/</sup> This communication requirement is similar to a previous requirement which had been part of an audit interpretation, AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*, for the auditor to consider whether matters related to management bias should be communicated to the audit committee.<sup>35/</sup>

Some commenters suggested that reporting potential management bias is unworkable and that all estimates involve some form of bias. One commenter suggested that the determination of bias should be related to critical accounting estimates instead of accounting estimates.

Auditing Standard No. 14 requires the auditor to, among other things, evaluate the qualitative aspects of the company's accounting practices<sup>36/</sup>

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<sup>34/</sup> See paragraph 27 of the Auditing Standard No. 14, *Evaluating Audit Results*, which includes requirements regarding the auditor's evaluation of bias in accounting estimates.

<sup>35/</sup> Following the original proposal of this standard, AU sec. 9312 was superseded when the Board adopted the risk assessment standards. The requirement of AU sec. 9312, however, was substantially included in the risk assessment standards.

<sup>36/</sup> See paragraphs 24 to 27 of Auditing Standard No. 14.

including potential bias in management's judgments about the amounts and disclosures in the financial statements.<sup>37/</sup> The new proposed standard was revised to require the auditor to communicate the results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements.<sup>38/</sup>

Additionally, as part of this communication, the auditor should communicate situations in which the results of his or her evaluation of the differences between (i) estimates best supported by audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. This communication is designed for the auditor to discuss the results of the auditor's evaluation of these matters as required under Auditing Standard No. 14. By linking these communication requirements with performance requirements in Auditing Standard No. 14, the new proposed standard provides context regarding the matters to be communicated. Further, the new proposed standard requires the auditor to communicate the results of procedures required under Auditing Standard No. 14, which makes it clear that matters to be communicated are the responsibility of the auditor and not management.

## **B. Conclusions Regarding Critical Accounting Estimates**

The original proposed standard required the auditor to communicate his or her evaluation regarding the reasonableness of the process used by management to develop critical accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates. This requirement is similar to a requirement in AU sec. 380.<sup>39/</sup>

Some commenters indicated that the requirement for the auditor to communicate the evaluation of the reasonableness of the process used by

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<sup>37/</sup> See paragraphs 30 to 31 of Auditing Standard No. 14.

<sup>38/</sup> See *generally* paragraphs 24-27 of Auditing Standard No. 14, which describe the auditor's responsibility relating to evaluating the qualitative aspects of the company's accounting practices.

<sup>39/</sup> See AU sec. 380.08.

management to develop critical accounting estimates might create the appearance that the auditor is making decisions on behalf of management. Additionally, another commenter indicated that the requirement was redundant of other communication requirements, such as the description of the process management used to develop critical accounting estimates and the basis for the auditor's conclusions regarding such estimates. Therefore, the requirement for the auditor to communicate the evaluation of the reasonableness of the process used by management to develop critical accounting estimates was removed from the new proposed standard. However, the requirement for the auditor to communicate the basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates was retained.

### **C. Financial Statement Presentation**

Similar to AU sec. 380.11, the original proposed standard required the auditor to communicate the auditor's evaluation of the quality, not just the acceptability under the applicable financial reporting framework, of the company's significant accounting policies and practices. This communication included a discussion of the (i) quality, clarity, and completeness of the company's financial statements, which includes related disclosures and (ii) consistency of the company's disclosures and of its selection and application of significant accounting policies and practices.

In general, commenters expressed concerns regarding the application of these requirements and what should be included in the communications to the audit committee. They indicated that it is not clear what is meant by the quality, clarity, and completeness of the company's financial statements and related disclosures. Some commenters indicated that the original proposed standard should retain the requirement from AU sec. 380<sup>40/</sup> related to the quality, clarity, and completeness of the company's financial statements, which include related disclosures.

After considering the concerns raised by commenters, the Board has included in the new proposed standard a requirement for the auditor to communicate to the audit committee the results of the auditor's evaluation of whether the presentation of the financial statements and related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial

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<sup>40/</sup> See AU sec. 380.11.

statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, classification of items, and bases of amounts set forth. This communication requirement results from the auditor's evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, as required by Auditing Standard No. 14.<sup>41/</sup>

#### **D. Matters for which the Auditor Consulted**

The original proposed standard included a new requirement for the auditor to communicate to the audit committee significant accounting matters for which the auditor has consulted outside the engagement team. These consultations could include discussions with the firm's national office or industry specialists, or consultations with external parties. The original proposed standard noted that consultations were not intended to include discussions with the engagement quality reviewer.

Several commenters supported this new requirement. Other commenters indicated that this requirement might cause the engagement team to decrease consultations. This requirement is not intended to discourage consultation.

Also, some commenters noted that consultations vary across firms, which might include a brief mention of issues in passing, chatting in the corridor, or consultation with the national office or with industry specialists. Therefore, commenters suggested that not all the consultations should be required to be communicated and that the standard should clarify that only consultations related to complex transactions that may be high risk, controversial, contentious, or relate to unusual financial reporting matters should be communicated. Other commenters indicated that such communication to the audit committee is unnecessary.

In order to narrow the communication to the most important matters, the new proposed standard requires the auditor to communicate matters that are difficult or contentious for which the auditor consulted outside the engagement

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<sup>41/</sup> See paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibility relating to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process. Such matters can be complex or unusual, and the auditor believes it is necessary to consult with the firm's national office or industry specialist, or with external parties. Difficult or contentious issues might arise in various stages of the audit, including in the auditor's evaluation of management's judgments, estimates, accounting policies, or an assessment of identified control deficiencies. Difficult or contentious issues might be described as those critical matters that have concerned the auditor when he or she is making the final assessment of whether the financial statements are presented fairly.

A difficult issue might not always be synonymous with a contentious issue. Rather, a difficult issue might be a matter that requires significant consultation. A contentious issue might be a matter that not only requires significant consultation but also leads to significant points of disagreement, debate, or deliberation between the auditor and management. Audit committees might better appreciate the importance of difficult or contentious matters if they are aware that such consultations took place.

Additionally, the note in the original proposed standard that indicated that these consultations were not intended to include discussions with the engagement quality reviewer was removed from the new proposed standard. The focus of the revised communication requirement is on the matters on which the auditor consulted, not on the parties involved in the consultation.

## **E. New Accounting Pronouncements**

The original proposed standard included a new requirement for the auditor to communicate, or determine that management has adequately communicated, to the audit committee the anticipated application of new accounting or regulatory pronouncements that are not yet effective, but which, upon adoption, may have a significant effect on the company's financial reporting. Companies generally disclose the potential effects of adoption of accounting standards that have been issued but not yet adopted in filings with the SEC.<sup>42/</sup>

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<sup>42/</sup> See Codification of Staff Accounting Bulletins, Topic 11.M and *Interpretive Release About Disclosure Considerations Relating to Foreign Operations and Foreign Currency Translation Effects*, Securities Act Release No. 6436 (November 18, 1982).

Some commenters supported the requirement to inform the audit committee about the effects of applying proposed or anticipated new accounting standards or regulatory pronouncements. However, other commenters indicated that this requirement is sufficiently covered through the current disclosures in the financial statements that provide information about the applicability of and effect of new accounting standards upon the company's adoption. Therefore, these commenters suggested that this requirement is not needed. Another commenter indicated that it seems unreasonable to require the auditor to anticipate the impact of future application of new accounting or regulatory pronouncements. Several commenters indicated that the wording of this requirement should be revised to state "the potential effects of adoption of accounting pronouncements that have been issued but are not yet effective and may have a significant effect on financial reporting."

In response to commenters, the new proposed standard has been revised to require the auditor to communicate to the audit committee situations in which, as a result of the audit procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting. This revised requirement is based on the auditor's procedures and situations in which the auditor has identified a concern regarding the anticipated application of a new accounting pronouncement. Management generally discloses in the financial statements the potential effects of adoption of accounting standards; therefore, the auditor would not be required to repeat management's disclosures. The auditor might be concerned about changes to accounting or disclosure processes, or systems that could affect financial reporting or whether management has devoted adequate resources to the pending adoption. Requiring the timely discussion of such matters is intended to allow time for the audit committee to properly consider the effects on future financial statements.

**F. SEC Requirements, Alternative Accounting Treatments, and Material Written Communications**

In addition to the requirement for the auditor to communicate critical accounting policies and practices, the original proposed standard also included

a requirement that was consistent with the SEC's Rule 2-07<sup>43/</sup> of regulation S-X. for the auditor to communicate alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items discussed with management.

Many commenters supported including these SEC requirements in the original proposed auditing standard. Other commenters indicated that the SEC requirements should be incorporated into the standard by reference only, because if the SEC changes its requirement in the future, incorporating by reference only would avoid potential inconsistencies between PCAOB standards and the SEC requirements. Another commenter suggested that a statement indicating that Rule 2-07 requires the auditor to communicate all critical accounting policies and practices as well as certain other matters should be included in a footnote to the original proposed standard.

In response to commenters, paragraph 13 of the new proposed standard was revised to more clearly articulate the requirement for the auditor to communicate his or her assessment of management's disclosures related to critical accounting policies and practices, along with any significant modifications to the disclosures of those policies and practices proposed by the auditor that management did not make. The new proposed standard retained the requirement for the auditor to communicate alternative accounting treatments permissible under the applicable financial reporting framework.

The original proposed standard did not incorporate the SEC's requirement for the auditor to communicate to the audit committee other material written communications between the auditor and management. Some commenters suggested this requirement should be included in the standard to capture other possible material written communications that might occur but are not addressed by requirements in the original proposed standard or by other PCAOB standards, such as the management representation letter. Therefore, the new proposed standard was revised to also incorporate the communication to the audit committee of other material written communications between the auditor and management.

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<sup>43/</sup> 17 CFR 210.2-07, Section 10A(k) of the Exchange Act also requires the auditor to report this information to the audit committee.

**IX. Significant Unusual Transactions**

Some commenters suggested the auditor should communicate to the audit committee information regarding significant unusual transactions that are outside the normal course of business for the company. The new proposed standard includes a requirement for the auditor to communicate to the audit committee significant transactions, of which the auditor is aware, that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.<sup>44/</sup> Under the new proposed standard, the communication would include the auditor's understanding of the business rationale for such transactions.<sup>45/</sup> The communication requirement is aligned with the performance requirement in AU sec. 316 which requires the auditor to gain an understanding of the business rationale regarding significant transactions that are outside the normal course of business or that otherwise appear unusual. This communication could provide the audit committee with an opportunity to receive the auditor's perspective of management's intentions regarding such transactions.

**X. Other Information in Documents Containing Audited Financial Statements**

The original proposed standard retained the requirement in AU sec. 380.12 for the auditor to communicate to the audit committee the auditor's responsibility for other information presented in documents containing audited financial statements, any related procedures performed, and the results of such procedures.<sup>46/</sup>

One commenter suggested that this responsibility should be incorporated into the engagement letter. The auditor's responsibility under AU

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<sup>44/</sup> See paragraph 71.g. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>45/</sup> See Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>46/</sup> See generally, paragraphs .04-.07 of AU sec. 550, which require that the auditor read the information and consider whether it is materially inconsistent with information in the financial statements or whether it contains any material misstatements.

sec. 550 requires the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation in the financial statements.

The Board considered the suggested change and decided not to include a requirement in the new proposed standard for the auditor to include this information in the engagement letter, because auditors, at times, perform additional procedures on the other information beyond reading the information for material inconsistencies. In addition, requiring the auditor to include the auditor's responsibilities for other information presented in documents containing audited financial statements to be included in the engagement letter may imply that the auditor was limited to only those procedures.

**XI. Management Consultations with Other Accountants**

The original proposed standard carried forward the requirement from AU sec. 380.14 for the auditor to communicate to the audit committee when the auditor is aware that management consulted with other accountants about auditing or accounting matters (e.g., management might consult with other accountants about the appropriate accounting for a transaction). In those situations, the original proposed standard required the auditor to communicate to the audit committee his or her views about significant matters that were the subject of such consultation.

Several commenters suggested that this requirement was no longer necessary, noting that the requirement in AU sec. 380 relating to discussion of management consultation with other accountants originated from a concern regarding "opinion shopping" by management. One commenter also noted that since accounting rules are becoming more complex and technical, it is considered good practice for management to consult with other accountants as experts to assist them.

The Board is not seeking to discourage consultations on complex accounting issues, but only to recognize that such consultations could warrant the audit committee's attention. Therefore, the Board revised the requirement in the new proposed standard to reflect that, when the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such

matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation.

## **XII. Going Concern**

The original proposed standard required the auditor to communicate to the audit committee, when applicable, certain matters relating to his or her evaluation of a company's ability to continue as a going concern. This communication might provide the audit committee with an "early warning" of the auditor's views regarding certain events and conditions that might affect the company's ability to continue as a going concern.

Some commenters indicated that including "could be substantial doubt" as the threshold for communication to the audit committee might result in the auditor communicating his or her consideration in situations in which the auditor does not have a significant doubt about the company's ability to continue as a going concern and would not provide the audit committee with meaningful information. The commenters suggested that the threshold for communication to the audit committee should be when the auditor believes there "is substantial doubt" about the company's ability to continue as a going concern. However, some commenters support the "could be" threshold, as it might provide an early warning to audit committee members of future problems.

In accordance with AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, the auditor has a responsibility to evaluate whether there is substantial doubt about the company's ability to continue as a going concern<sup>47/</sup> for a reasonable period of time.<sup>48/</sup> The auditor's evaluation is based on, among other things, his or her knowledge of relevant conditions and events that exist at or occurred prior to the date of the auditor's report. AU sec. 341.03a notes that the auditor may identify information about certain conditions and events that, when considered in the aggregate, indicate

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<sup>47/</sup> The PCAOB and the Financial Accounting Standards Board have ongoing projects regarding accounting and auditing issues related to a company's ability to continue as a going concern. If appropriate, the PCAOB might reconsider communication with the audit committee regarding such issues in connection that project.

<sup>48/</sup> AU sec. 341.02.

there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.<sup>49/</sup> Examples of such conditions and events are negative trends, indicators of possible financial difficulties, internal difficulties, or external matters that have occurred. The significance of these conditions and events depends on the circumstances. The auditor might obtain additional information about such conditions and events, as well as appropriate evidential matter, to support information that mitigates the auditor's doubt.

The new proposed standard requires the auditor to communicate the conditions and events the auditor identified that, when considered in the aggregate, indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. The remaining matters related to going concern to be communicated depend on the auditor's conclusion.

If the auditor's doubt is mitigated, the new proposed standard requires the auditor to communicate the information that mitigates the auditor's doubt, including, if applicable, a discussion of management's plans. The auditor's doubt might be mitigated by obtaining more information about the conditions and events or by considering management's plans for dealing with the adverse effects of the conditions and events and whether such plans can be effectively implemented. If the auditor concludes that there is substantial doubt about a company's ability to continue as a going concern, the auditor should communicate to the audit committee the effects, if any, on the financial statements and the adequacy of the related disclosure and the effects on the auditor's report.<sup>50/</sup>

Several commenters were concerned that the original proposed standard did not adequately describe that management initially considers a company's ability to continue as a going concern and the auditor would then evaluate management's consideration. Under AU sec. 341, the responsibility of the auditor is to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. Therefore, the new proposed standard was not revised to indicate that

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<sup>49/</sup> A reasonable period of time as described in AU sec. 341.02 is not to exceed one year beyond the date of the financial statements being audited.

<sup>50/</sup> See *generally*, AU secs. 341.12-.16.

the consideration of a company's ability to continue as a going concern is initially made by management and evaluated by the auditor.

### **XIII. Uncorrected and Corrected Misstatements**

The original proposed standard required the auditor to provide the audit committee with the schedule of uncorrected misstatements<sup>51/</sup> relating to accounts and disclosures that was presented to management. Several commenters indicated that audit committees would not find value in information presented at the same level of detail as presented to management. The Board decided to retain the requirement because presenting a schedule that shows only the net effect of the uncorrected misstatements rather than the individual misstatements may be misleading. The new proposed standard is not a significant change from AU sec. 380.10, which required the presentation to the audit committee of a schedule of uncorrected misstatements. This schedule is similar to the summary of uncorrected misstatements included in or attached to the management representation letter.

Several commenters suggested that the standard needed to clarify what is meant by uncorrected misstatements relating to disclosures. Commenters suggested that there was no need for the auditor to communicate a long list of disclosures that were not made because the matters were immaterial or not present in the company's circumstances. Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial, and communicate those to management on a timely basis.<sup>52/</sup> According to Auditing Standard No. 14, a misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework.<sup>53/</sup> The requirement to communicate misstatements related to disclosures would refer only to those misstatements

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<sup>51/</sup> Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include both omissions and the presentation of inaccurate or incomplete disclosures.

<sup>52/</sup> See paragraphs 10 and 15 of Auditing Standard No. 14.

<sup>53/</sup> See paragraph A2 of Auditing Standard No. 14.

that the auditor has accumulated throughout the audit that are not clearly trivial and have been reported to management. Therefore, the Board retained the requirement as originally proposed.

The original proposed standard also required the auditor to communicate the basis for the auditor's determination that the uncorrected misstatements were immaterial, including the qualitative factors<sup>54/</sup> considered. Many commenters noted that management has responsibility for evaluating, quantitatively and qualitatively, the materiality of uncorrected misstatements and communicating its conclusions to the audit committee. Therefore, the new proposed standard was revised to require the auditor to discuss with the audit committee, or determine that management has adequately discussed, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors<sup>55/</sup> considered.

The original proposed standard also required the auditor to communicate those corrected misstatements that might not have been detected except through the auditing procedures performed, including the implications that such corrected misstatements might have on the financial reporting process.

Several commenters noted that it appears that this requirement relates to the auditor's consideration of the impact a misstatement might have on an auditor's consideration of a company's internal control over financial reporting. Commenters also noted that the Board already has communication requirements related to significant deficiencies and material weaknesses for integrated audits in Auditing Standard No. 5 and for audits of financial statement only in AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*. The Board recognizes that there are already auditing standards regarding communication of significant deficiencies and material weaknesses; however, the intent of this requirement is to inform the audit committee of misstatements that were only detected through audit procedures.

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<sup>54/</sup> See generally, Appendix B of Auditing Standard No. 14, which discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

<sup>55/</sup> Ibid.

Some commenters suggested that the standard should specifically require the auditor to request management to correct the uncorrected misstatements. The Board did not make this change because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements. Section 13(i) of the Exchange Act, requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.

The release accompanying the original proposed standard included a question that asked whether all corrected misstatements, including those detected by management, should be communicated to the audit committee. Several commenters supported communicating misstatements detected by management to the audit committee, as they may indicate challenges within the financial reporting process that the board or management should address. However, many commenters were not supportive of the auditor communicating misstatements detected by management, because the auditor may not have knowledge of all such adjustments due to the nature of a company's financial statement close process and the timing of the auditor's procedures. Commenters suggested that such a requirement would likely result in the auditor expending significant effort to identify misstatements that the company's internal controls previously identified in the financial close process. Accordingly, the new proposed standard does not include a requirement for the auditor to communicate misstatements detected by management.

#### **XIV. Departure from the Standard Auditor's Report**

The original proposed standard included a requirement for the auditor to communicate to the audit committee when the auditor expects to modify the opinion in the auditor's report or include an explanatory paragraph.<sup>56/</sup> The original proposed requirement indicated that the communication would include the reasons for the modification or explanatory paragraph and the proposed wording of the report. The requirement was intended to provide the basis for a discussion between the auditor and the audit committee in those circumstances in which the auditor expects to depart from the standard auditor's report.

Such communication enables the audit committee to be aware of the nature of any specific matters that the auditor expects to highlight in the

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<sup>56/</sup> See AU secs. 508.11-74 and .76.

auditor's report. In addition, these communications provide the audit committee with an opportunity to obtain further clarification from the auditor about the modification. Additionally, this communication also provides the audit committee with an opportunity to provide the auditor with further information and explanations regarding the matters that are expected to be included in the auditor's report.

Several commenters suggested excluding from the communication requirement those report modifications related to the emphasis of a matter or the adoption of a new accounting principle because these matters are subject to other communication requirements or are clearly disclosed in the financial statements. For example, AU sec. 508, provides several reasons that an audit report might be modified, including a change in accounting principle or an emphasis of a matter. In fulfilling its responsibility to oversee the audit and the financial reporting process, it is important for the audit committee to understand the reasons an auditor might depart from the standard auditor's report. Accordingly, the requirement was not changed.

#### **XV. Disagreements with Management**

The original proposed standard included a requirement for the auditor to communicate to the audit committee any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or the auditor's report. This requirement was retained from AU sec. 380.13. Examples of disagreements might include disagreements with management about the application of accounting principles to the company's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements might also arise regarding the scope of the audit, disclosures to be made in the company's financial statements, or the wording of the auditor's report. This communication requirement does not include differences of opinion based on incomplete facts or preliminary information that are later resolved prior to the issuance of the auditor's report.

Some commenters suggested changing the standard to include examples clarifying what is meant by "matters." The term "matters" appears in AU sec. 380.13 and has been used in practice. In order not to inadvertently change practice in this area, the Board is not adding any examples to the standard.

Other commenters suggested including a reference to the SEC's requirement to report disagreements upon a change in the auditor. The new proposed standard was not revised because the communication requirement in the standard relates to disagreements occurring during the current audit period. However, the SEC requires reporting of the disagreement only upon the resignation or dismissal of the auditor or the auditor's refusal to stand for reappointment within the subsequent two-year period. A reference to the SEC requirement was not included in the new proposed standard, because including such reference in the standard might lead the auditor to communicate disagreements to the audit committee only upon the auditor's resignation, dismissal, or refusal to stand for reelection.

#### **XVI. Difficulties Encountered in Performing the Audit**

The original proposed standard included the requirement from AU sec. 380.16 for the auditor to inform the audit committee of any significant difficulties encountered during the audit. Some commenters suggested adding additional matters, moving other matters elsewhere within the original proposed standard, or making specific revisions to the language of the standard. The Board considered the suggested changes to the original proposed standard and revised certain language. However, the Board also determined that some changes would not substantially improve the standard; therefore, the new proposed standard was not revised for those changes.

In the new proposed standard significant difficulties encountered during the audit include, but are not limited to:

- Significant delays by management, the unavailability or company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;
- An unreasonably brief time within which to complete the audit;
- Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;
- Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and

- Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

One commenter suggested adding additional matters to the standard that should be communicated to the audit committee, such as a requirement to communicate information regarding related party transactions. Whether the auditor should be required to communicate information regarding the company's related party transactions depends on whether the transactions fall within one of the categories identified in the new proposed standard, such as a significant risk, the subject of an explanatory paragraph, a disagreement with management, or a difficulty encountered in performing the audit. In addition, nothing in the new proposed standard prohibits the auditor from communicating such information to the audit committee. Whether to require additional auditor communication to the audit committee regarding related party transactions will be considered through the Board's related party standard-setting project.

## **XVII. Other Matters**

The original proposed standard included a requirement for the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process, including situations in which the auditor is aware of complaints or concerns raised regarding accounting or auditing matters. This requirement acknowledges that there are other matters that may be beneficial to the audit committee's oversight of the financial reporting process when communicated to the audit committee. This communication could provide the audit committee with an opportunity to better understand management's intentions regarding such transactions.

The Act requires the audit committees of listed companies to establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting control, or auditing matters, and the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters. Some commenters suggested that the original proposed standard be revised to clarify that the communication does not include matters previously reported to the auditor by the audit committee or that the auditor has determined were previously communicated to the audit committee by management. The Board does not expect that the auditor would repeat information provided to him or

her by the audit committee in fulfilling this requirement. Further, if the auditor determines that a matter not addressed in the standard is significant to the oversight of the company's financial reporting process and should be communicated to the audit committee, the fact that management previously has communicated the matter in some fashion to the audit committee should not prevent the auditor from making a separate communication on that matter. Accordingly, the language from the original proposed standard was retained.

The new proposed standard requires the auditor to inquire of the audit committee about whether it is aware of complaints or concerns regarding accounting or auditing matters. Similarly, the auditor also might become aware of additional complaints or concerns regarding accounting or auditing matters that were not received through the company's process, and therefore, the audit committee might be better able to exercise its oversight activities if the auditor informed the audit committee of these matters. The new proposed standard requires the auditor to communicate these matters to the audit committee.

AU sec. 380 required the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process. The new proposed standard takes the additional step of requiring the auditor to communicate to the audit committee complaints or concerns that have come to the auditor's attention.

One commenter suggested specifying that the complaints or concerns may indicate the existence of fraud or illegal acts. The footnote in the original proposed standard acknowledged that complaints or concerns might relate to fraud or illegal acts and that the auditor has specific communication requirements for those matters in AU sec. 316, and AU sec. 317, *Illegal Acts by Clients*.<sup>57/</sup> Accordingly, no change was made to the requirement.

One commenter noted that the auditor might not be knowledgeable as to what is significant regarding the rules, regulations, laws, and duties governing the audit committee's oversight of the financial reporting process and suggested changing "significant" to "might be relevant." The Board did not

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<sup>57/</sup> Additionally, Rule 13(b)(2)(iv) under the Exchange Act 17 CFR 240.13(b)(2)(iv) states that management shall not coerce, manipulate, mislead, or fraudulently influence the auditor, including preventing the auditor from communicating matters to the company's audit committee.

make this change, because through the comments, audit committee members indicated that they are primarily interested in the communication of significant matters related to the financial reporting process. Communicating other matters that "might be relevant" could lead to the communication of matters that might be trivial to the audit committee.

The new proposed standard requires the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.

#### **XVIII. Form and Documentation of Communications**

The original proposed standard retained the requirement for auditors to communicate to the audit committee in writing or orally the matters required to be communicated, unless otherwise specified in the original proposed standard. Some commenters suggested that the standard should require all communications to be in writing, while other commenters indicated that the standard should continue to provide flexibility in the manner of communication.

The new proposed standard was not revised to require all communications to be in writing. The Board's intention is to promote effective two-way communication between the auditor and the audit committee, whether through presentations, written reports, or interactive discussions. Written communications might provide the auditor with a basis to lead an active two-way discussion with the audit committee. The form of communication may depend on the nature of the matter to be communicated. For example, written information often makes it easier for the audit committee to understand highly complex information (e.g., information about critical accounting estimates). However, having a dialogue on key matters often is an important factor in effective communications between the auditor and the audit committee.

Several commenters suggested the standard should retain the provision in AU sec. 380.03 that written communications to the audit committee are intended solely for the information and use of the audit committee, board of directors, and management, if appropriate, and are not intended to be and should not be used by anyone other than those specified parties. Commenters were concerned that the absence of such a requirement might result in the

unintended consequence of less candid discussions between the auditor and the audit committee due to the knowledge that the written information could be shared with other parties or could result in another party inappropriately relying on the written information without the appropriate context. The original proposed standard included a footnote reference to AU sec. 532, *Restricting the Use of an Auditor's Report*, which applies to certain reports, including those provided to the audit committee, on matters coming to the auditor's attention during the audit. The new proposed standard was not revised to include additional language regarding the restriction of the audit committee communication; however, the new proposed standard retains the footnote reference to AU sec. 532.

#### **XIX. Timing**

The Board considers communications with audit committees to be an integral part of the audit process. AU sec. 380 stated that audit committee communications are incidental to the audit and are not required to occur before the issuance of the auditor's report on the entity's financial statements so long as the communications occur on a timely basis.<sup>58/</sup> The original proposed standard required the auditor to communicate the matters required by the standard in a timely manner and prior to the issuance of the auditor's report.

Commenters generally agreed that audit committee communications should occur in a timely manner and prior to the issuance of the auditor's report. One commenter suggested that the original proposed standard should specify the timing of certain communications, because, if the auditor only communicates matters shortly before the issuance of the auditor's report it may be too late to be considered timely. Another commenter suggested that the original proposed standard should emphasize that the discussion of the terms of the engagement, audit strategy, and significant risks should be discussed with the audit committee early in the planning phase of the audit. Another commenter was concerned that the auditor might not have completed necessary audit procedures until after the last audit committee meeting and that the auditor could follow-up on the resolution of open audit issues after the audit report is issued.

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<sup>58/</sup> AU sec. 380.04.

The new proposed standard does not emphasize the specific timing of certain communications because the appropriate timing might vary depending on the circumstances. As noted in the new proposed standard, the appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and any corrective or follow-up action needed. However, the timing of the communication should be prior to the issuance of the auditor's report. The new proposed standard retains the requirement as originally proposed for communications to occur in a timely manner and prior to the issuance of the auditor's report. However, as noted above, the auditor may wish to consider whether the required communications will affect the audit strategy and adjust the timing of those communications accordingly.

Some commenters also suggested that the original proposed standard should not impose requirements that would require the auditor to communicate the same matters from year to year. AU sec. 380 stated that, generally, it is not necessary to repeat the communication of recurring matters each year.<sup>59/</sup> However, the new proposed standard requires the auditor to communicate all communications required by the standard to the audit committee prior to the issuance of the auditor's report, which occurs at least annually, because the matters covered by the standard are limited to significant matters and these matters may change based on changes in the economy, the volume of transactions, or their significance to the audit or financial statements. Although the communications are required to be made at least annually, the time spent on the discussion of matters presented could vary from year-to-year based on circumstances or other factors, such as a change in the members of the audit committee.

Providing these required communications to the audit committee in a timely manner and prior to the issuance of the auditor's report will allow the audit committee the opportunity to take any action it may deem appropriate to address the matters communicated prior to the issuance of the auditor's report.

Several commenters suggested that the original proposed standard should discuss the timing of audit committee communications regarding interim reviews. One commenter also suggested that the required communications regarding interim reviews should include discussion of the nature and extent of interim review procedures and that these procedures are based on a level of

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<sup>59/</sup> AU sec. 380.05.

work less robust than that performed during the annual audit. The original proposed standard included an amendment to paragraph .36 of AU sec. 722, *Interim Financial Information*, to require that the auditor complete any necessary communications with the audit committee prior to the company's filing of its interim financial information with a regulatory agency, such as the SEC. Accordingly, no change was made to the new proposed standard.

**XX. Adequacy of the Two-Way Communication Process**

The original proposed standard included a requirement for the auditor to evaluate whether the two-way communication between the auditor and the audit committee was adequate to support the objective of the audit. If those communications were not effective, the original proposed standard required the auditor to evaluate the effects, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence. That requirement was included to emphasize that effective two-way communication is beneficial to achieving the objectives of the audit.

Many commenters acknowledged that inadequate two-way communication could have an effect on the auditor's assessment of the risks of material misstatement, which might impact the nature, timing, and extent of audit procedures. However, several commenters suggested that an evaluation of the adequacy of the two-way communication can only be adequate if both parties are involved. These commenters suggested that if only the auditor evaluates the effectiveness based on his or her understanding of what was communicated, that evaluation would not provide information about the audit committee's understanding of that communication. Commenters did not believe that the evaluation by the auditor would promote two-way communication between the auditor and audit committee. Other commenters suggested expanding the requirement to require the auditor to evaluate the adequacy of the two-way communication between management and the audit committee.

As suggested by commenters, the requirement to evaluate whether the two-way communications between the auditor and the audit committee have been adequate was removed from the new proposed standard. However, as part of understanding the company's control environment in Auditing Standard No. 12, the auditor assesses whether the board or audit committee understands and exercises oversight responsibility over financial reporting and

internal control.<sup>60/</sup> Other PCAOB standards require that, in an audit of financial statements, if the auditor becomes aware, or in an integrated audit, the auditor concludes, that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.<sup>61/</sup> Therefore, removing the requirement from this standard does not change the auditor's responsibility for assessing the audit committee's effectiveness under existing PCAOB standards.

#### **XXI. Amendments to PCAOB Standards**

The original proposed standard amended AU sec. 722 to be consistent with the original proposed standard. Several commenters were concerned that the amendments to AU sec. 722 increased the communication requirements related to an interim review. Additionally, some commenters suggested the amendments to AU sec. 722 could be redundant and unnecessary on an interim basis for ongoing issues that are communicated as part of the annual audit. Commenters also indicated that, due to the nature of the procedures performed in the interim review, the auditor may be unable to provide the audit committee with the same level of detail as compared to communications that are based on information obtained during the annual audit. The original proposed standard did not amend paragraph .35 of AU sec. 722, which limits the communications to the audit committee in an interim review to the effect of significant, events, transactions, and changes in accounting estimates that the auditor considered when conducting the review of interim financial information. Additionally, the amendments do not require the auditor to repeat communications that were made as part of the annual audit. Therefore, the amendments to AU sec. 722 are retained from the original proposed standard.

Technical conforming changes are being made to the following standards. The amendments are consistent with a requirement in the original proposed standard and the new proposed standard for the auditor to communicate to the audit committee (i) in a timely manner before the issuance of the auditor's report and (ii) the results of the auditor's procedures:

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<sup>60/</sup> See paragraphs 23-24 of Auditing Standard No. 12.

<sup>61/</sup> See paragraph 79 of Auditing Standard No. 5 and paragraph 5 of AU sec. 325.

- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*;
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*;
- AU sec. 317, *Illegal Acts by Clients*;
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*;
- AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and
- AU sec. 711, *Filings Under Federal Securities Statutes*.

The other amendments to PCAOB Standards, included as part of the original proposed standard, were primarily related to changes in references to the original proposed standard and other conforming changes. There were no significant comments on these other amendments, and they were substantively retained as originally proposed.

## **APPENDIX 5**

### ***Comparison of the Objectives and Requirements of the Proposed Auditing Standard, Communications with Audit Committees, to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants***

#### ***Introduction***

This appendix discusses certain significant differences between the objectives and requirements of the accompanying proposed auditing standard, *Communications with Audit Committees*, and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and analogous standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants.

The comparable IAASB standards are International Standard on Auditing ("ISA") 210, *Agreeing the Terms of Audit Engagements*, and ISA 260, *Communication with Those Charged with Governance*. The comparable ASB standards are the issued Statement on Auditing Standards ("SAS") 122, *Statement on Auditing Standards: Clarification and Recodification*,<sup>1/</sup> AU-C Section 210, *Terms of Engagement*, and AU-C Section 260, *The Auditor's Communication with Those Charged with Governance*.<sup>2/</sup> The analysis does not

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<sup>1/</sup> In October 2011, the ASB issued SAS No. 122, which contains the Preface to Codification of Statements on Auditing Standards, *Principles Underlying an Audit Conducted in Accordance with Generally Accepted Auditing Standards*, and 39 clarified SASs. SAS 122 identifies the section within the AICPA codification with "AU-C" section numbers. See <http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/DescriptionofClarifiedSASs.aspx>.

<sup>2/</sup> Other standards by the IAASB and the ASB were considered in this comparison to the extent they include comparable requirements, including ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, ISA 450, *Evaluation of Misstatements Identified During the Audit*, ISA 570, *Going Concern*, ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, AU-C Section 240, *Consideration of Fraud in a*

cover the application and explanatory material in the IAASB standards or ASB standards.<sup>3/</sup>

This appendix is provided for informational purposes only. It is not a substitute for the proposed auditing standard itself, which is presented in Appendix 1 of this release.

This analysis may not represent the views of the IAASB or ASB regarding the interpretation of their standards.

## **Objectives**

### *PCAOB*

The proposed auditing standard replaces AU sec. 310, *Appointment of the Independent Auditor*, and AU sec. 380, *Communication With Audit Committees*. Given the responsibility of many audit committees for the appointment and retention of the auditor, the proposed auditing standard combines the requirements from the Board's standards, AU secs. 310 and 380, into one auditing standard.

The proposed auditing standard includes four objectives for the auditor, which reflect both the appointment and retention of the auditor as well as the overall communication responsibilities. The objectives of the auditor are to:

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*Financial Statement Audit*, AU-C Section 450, *Evaluation of Misstatements Identified During the Audit*, AU-C Section 600, *Using the Work Others – Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, Proposed SAS, *The Auditor's Consideration of An Entity's Ability to Continue as a Going Concern (Redrafted)*, and SAS 118, *Other Information in Documents Containing Audited Financial Statements*.

<sup>3/</sup> Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

- a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
- b. Obtain information from the audit committee relevant to the audit;
- c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
- d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

### *IAASB and ASB*

ISA 210 and AU-C Section 210 both include an objective to establish whether the preconditions for an audit are present. The proposed auditing standard does not include this objective, because some of the related requirements in the ISA and SAS are not applicable to audits performed under PCAOB standards, such as determining whether the financial reporting framework is acceptable. For audits performed under PCAOB standards, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

Both ISA 260 and AU-C Section 260 include an objective for the auditor to promote effective two-way communication between the auditor and those charged with governance. The proposed auditing standard does not include a similar objective because the standard does not include a requirement to promote effective two-way communication.

## **Appointment and Retention**

### **Significant Issues Discussed with Management In Connection with the Auditor's Appointment or Retention**

#### *PCAOB*

The proposed auditing standard requires the auditor to discuss with the audit committee any significant issues discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

*IAASB and ASB*

ISA 210 and AU-C Section 210 do not include a similar requirement.

**Establish an Understanding of the Terms of the Audit**

*PCAOB*

The proposed auditing standard requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the objective of the audit, the responsibilities of the auditor, and the responsibilities of management, and recording the understanding of the terms in an engagement letter. The proposed auditing standard also requires the auditor to provide the engagement letter to the audit committee annually. The proposed standard requires the auditor to have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties is other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Additionally, the proposed auditing standard requires the auditor to decline to accept, continue, or perform the engagement if the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee.

*IAASB and ASB*

ISA 210 and AU-C Section 210 require the auditor to agree on the terms of the audit engagement with management and, where appropriate, those charged with governance.

ISA 210 and AU-C Section 210 require the engagement letter to be in writing, although there is no requirement that the engagement letter be given to the audit committee or that it be signed by the audit committee, or its chair on behalf of the audit committee, or otherwise be acknowledged by the audit committee. Additionally, ISA 210 states that for recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. Accordingly, ISA 210 permits the auditor to not send a new audit engagement letter or other written agreement each period.

AU-C Section 210 requires the auditor to assess whether circumstances require the terms of the audit engagement to be revised. If the auditor concludes that the terms of the preceding engagement need not be revised for the current

engagement, the auditor should remind management of the terms of the engagement, and the reminder should be documented.

Both ISA 210 and AU-C Section 210 also establish requirements for the auditor to determine whether the preconditions for an audit exist. The proposed auditing standard does not include similar requirements as these requirements were either not applicable to audits performed under PCAOB standards or were addressed through the requirements in the proposed auditing standard for establishing an understanding of the terms of the audit engagement with the audit committee.

ISA 210 includes requirements regarding financial reporting standards supplemented by law or regulation as well as requirements regarding the financial reporting framework. AU-C Section 210 does not include similar requirements. The proposed auditing standard also does not include similar requirements as they are not relevant to the audits performed under PCAOB standards.

ISA 210 and AU-C Section 210 also include requirements regarding limitation of scope prior to audit engagement acceptance, other factors affecting audit engagement acceptance, and acceptance of a change in the terms of the audit engagement. The proposed auditing standard does not include such requirements as they are not applicable to audits performed under PCAOB standards.

AU-C Section 210 also includes requirements regarding initial audits and re-audits. The proposed auditing standard does not include similar requirements, although similar requirements are included in the Board's standard, AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

Additionally, ISA 260 and AU-C Section 260 include a requirement for the auditor to communicate with those charged with governance the form, timing, and expected general content of communications. The proposed auditing standard does not include this requirement; however, the proposed auditing standard does not preclude the auditor from communicating these matters to the audit committee.

## **Obtaining Information and Communicating the Audit Strategy**

### **Obtaining Information Relevant to the Audit**

#### *PCAOB*

The proposed auditing standard requires the auditor to inquire of the audit committee about whether it is aware of matters that might be relevant to the audit, including, but not limited to, knowledge of violations or possible violations of laws or regulations and complaints or concerns raised regarding financial reporting matters. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, includes a requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks.<sup>4/</sup> The requirement in the proposed auditing standard complements the requirement in Auditing Standard No. 12.

#### *IAASB and ASB*

ISA 260 and the AU-C Section 260 do not contain a similar requirement for the auditor to inquire of matters that might be relevant to the audit, including but not limited to, knowledge of violations or possible violations of laws or regulations and complaints or concerns raised regarding financial reporting matters. However, ISA 240 requires the auditor to make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity. AU-C Section 240 contains a similar requirement as ISA 240.

### **Overall Audit Strategy and Timing of the Audit**

#### *PCAOB*

The proposed auditing standard requires the auditor to communicate to the audit committee an overview of the overall audit strategy, including a discussion of the significant risks identified during the auditor's risk assessment procedures, and the timing of the audit. As part of communicating the overall audit strategy, the proposed auditing standard requires the auditor to communicate the following matters to the audit committee, if applicable:

- a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;

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<sup>4/</sup> Paragraph 54 of Auditing Standard No. 12.

- b. The extent to which the auditor plans to use the work of the company's internal audit function in an audit of financial statements;
- c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;
- d. The names, locations, planned roles, and responsibilities, including the scope of audit procedures, of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and
- e) The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors.

In addition, the auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

*IAASB and ASB*

Similar to the proposed auditing standard, ISA 260 and AU-C Section 260 require the auditor to communicate an overview of the planned scope and timing of the audit. However, ISA 260 and AU-C Section 260 do not require the auditor to communicate significant changes to the planned scope and timing of the audit. Further, ISA 260 and AU-C Section 260 do not include requirements for the auditor to communicate information about specialized skill or knowledge need to apply audit procedures, using the work of internal auditors, or using the work of other company personnel or third parties working under the direction of management.

ISA 260 and AU-C Section 260 do not include requirements for the auditor to communicate information about the names, locations, planned roles, and responsibilities, including the scope of audit procedures of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures. However, ISA 600 and AU-C Section 600, include requirements for the auditor to communicate certain matters to those charged with governance including: an overview of the type of work to be performed on the financial information of the components; an overview of the nature of the

group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components; instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work; any limitation on the group audit; and fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or other where the fraud resulted in a material misstatement of the group financial statements. In addition, AU-C Section 600 also includes a requirement for the auditor to communicate the basis for the decision to make references to the audit of a component auditor in the auditor's report on the group financial statements.

## **Results of the Audit**

### **Accounting Policies, Practices, and Estimates**

#### *PCAOB*

The proposed auditing standard acknowledges that if management communicates matters related to accounting policies, practices, and estimates to the audit committee, the auditor does not need to communicate these matters at the same level of detail as management as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor is required to communicate any omitted or inadequately described matters to the audit committee.

These matters include:

- a. Significant accounting policies and practices, including: (1) management's initial selection of, and changes in significant accounting policies, or the application of such policies in the current period; (2) the methods management used to account for significant unusual transactions; and (3) the effect of significant accounting policies on financial statements or disclosures in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.
- b. All critical accounting policies and practices, including: (1) the reasons certain policies and practices are considered critical, and (2) how current and anticipated future events might affect the

determination of whether certain policies and practices are considered critical.

- c. Critical accounting estimates, including: (1) a description of the process management used to develop critical accounting estimates; (2) management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and (3) any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.

#### *IAASB*

ISA 260 requires the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

#### *ASB*

AU-C Section 260 requires the auditor to communicate the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. AU-C Section 260 also provides that, when applicable, the auditor should determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of the estimate.

### **Auditor's Evaluation of the Quality of the Company's Financial Reporting**

#### *PCAOB*

The proposed auditing standard requires the auditor to communicate the following matters to the audit committee:

- a. Qualitative aspects of significant accounting policies and practices. The results of the auditor's evaluation of and conclusions about the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements. The proposed auditing standard also requires the auditor to communicate when the

auditor's evaluation of estimates indicates possible bias on the part of the company's management.

- b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.
- c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.
- d. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth.
- e. Matters for which the auditor consulted. Matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.
- f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.
- g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor.
- h. Material written communications. Other material written communications between the auditor and management.

*IAASB*

ISA 260 requires the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity. ISA 260 also requires the auditor to communicate to those charged with governance written representations the auditor is requesting.

*ASB*

AU-C Section 260 requires the auditor to communicate the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable the auditor should:

- a. Explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity, and
- b. Determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of the estimates.

AU-C Section 260 also requires the auditor to communicate to those charged with governance written representations the auditor is requesting.

**Significant Unusual Transactions**

*PCAOB*

The proposed auditing standard requires the auditor to communicate to the audit committee significant transactions, of which the auditor is aware, that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature. Such communication should include the auditor's understanding of the business rationale for such transactions.

*IAASB and ASB*

The ISAs or the AU-Cs do not include a similar requirement.

**Other Information in Documents Containing Audited Financial Statements**

*PCAOB*

When other information is presented in documents containing audited financial statements, the proposed auditing standard requires the auditor to communicate to the audit committee his or her responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.

AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires that if the auditor identifies a material inconsistency in the other information presented in documents containing audited financial statements, that is not revised by management to eliminate the material inconsistency, the auditor should communicate the material inconsistency to the audit committee. The auditor should also consider other actions, such as revising the audit report to include an explanatory paragraph describing the material inconsistency, withholding the use of the report in the document, and withdrawing from the engagement. The auditor should also communicate a material misstatement of fact to the audit committee, if the material misstatement of fact is not corrected.

*IAASB*

ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, requires that if the auditor identifies a material inconsistency in the other information in documents containing audited financial statements, and revision of the other information is necessary and management refuses to make the revision then the auditor shall communicate this matter to those charged with governance and (a) include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*; or (b) withhold the auditor's report; or (c) withdraw from the engagement, where withdrawal is possible under applicable law or regulation. ISA 720 also requires the auditor to notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action if there is a material misstatement of fact in the other information which management refuses to correct.

*ASB*

SAS 118 contains similar requirements to those in the proposed auditing standard.

**Management Consultation with Other Accountants**

*PCAOB*

The proposed auditing standard requires that when the auditor is aware that management consulted with other accountants about significant auditing or accounting matters, the auditor is required to communicate his or her views about such matters that were the subject of such consultation.

*IAASB*

The ISA 260 does not include a similar requirement.

*ASB*

AU-C Section 260 includes a similar requirement as the proposed auditing standard.

**Going Concern**

*PCAOB*

The proposed auditing standard includes a requirement for the auditor to communicate to the audit committee, when applicable, certain matters regarding the auditor's evaluation of the company's ability to continue as a going concern. These matters include (a) conditions and events the auditor identified that, when considered in the aggregate, indicate there could be a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time; (b) if the auditor's doubt is mitigated, the information that mitigated the auditor's doubt, including, if applicable, a discussion of management's plans; (c) if the auditor concludes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the effects, if any, on the financial statements and the adequacy of the related disclosures and the effects on the auditor's report.

*IAASB*

ISA 570, *Going Concern*, requires the auditor to communicate events or conditions identified that may cast doubt on the entity's ability to continue as a

going concern. This communication includes whether the events or conditions constitute a material uncertainty; whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and the adequacy of related disclosures in the financial statements.

#### *ASB*

The proposed SAS, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (Redrafted)*, requires the auditor to communicate with those charged with governance the nature of the conditions or events identified, the possible effects on the financial statements and the adequacy of related disclosures in the financial statements, and the effects on the auditor's report. Such communication is required if, after considering identified conditions and events in the aggregate and after considering management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.

#### **Uncorrected and Corrected Misstatements**

##### *PCAOB*

The proposed auditing standard requires the auditor to provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management. The proposed auditing standard also requires the auditor to discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors considered. Additionally, the proposed auditing standard requires the auditor to communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could cause future period financial statements to be materially misstated. The auditor also should communicate to the audit committee those corrected misstatements that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

##### *IAASB and ASB*

ISA 450 and AU-C Section 260 include requirements for the auditor to communicate uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. The auditor's communication should identify the material uncorrected misstatements individually. Additionally, under ISA 450 and the AU-C Section 260, the auditor is

required to communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

ISA 450 and AU-C Section 450 require the auditor to request that uncorrected misstatements be corrected. The proposed auditing standard does not require the auditor to make this request, because under SEC rules the financial statements are required to reflect all material correcting adjustments identified by the auditor.

ISA 450 does not include a requirement for the auditor to communicate corrected misstatements to those charged with governance. AU-C Section 260 requires the auditor to communicate material, corrected misstatements that were brought to the attention of management as a result of audit procedures.

### **Disagreements with Management**

#### *PCAOB*

The proposed auditing standard includes a requirement for the auditor to communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report. The proposed auditing standard further notes that disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved prior to the issuance of the auditor's report.

#### *IAASB*

The ISAs do not include a similar requirement.

#### *ASB*

AU-C Section 260 requires the auditor to communicate disagreements with management, if any.

### **Other Matters**

#### *PCAOB*

The proposed auditing standard includes a requirement for the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process. This communication

includes complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.

#### *IAASB and ASB*

ISA 260 and AU-C Section 260 include a similar requirement for the auditor to communicate other matters to those charged with governance that, in the auditor's professional judgment, are significant and relevant to the oversight of the financial reporting process.

### **Form and Documentation of Communications**

#### *PCAOB*

The proposed auditing standard requires the auditor to communicate the matters to the audit committee either orally or in writing, unless otherwise specified in the proposed auditing standard. The proposed auditing standard also requires the auditor to document the communications in the workpapers whether such communications took place orally or in writing. Additionally, the proposed auditing standard requires the auditor to include a copy of or a summary of management's communication provided to the audit committee in the audit documentation if management communicated accounting policies, practices, and estimates to the audit committee.

#### *IAASB*

ISA 260 requires the auditor to communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communication need not include all matters that arose during the course of the audit.

#### *ASB*

AU-C Section 260 requires the auditor to communicate in writing with those charged with governance significant findings or issues from the audit if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved.

## **Timing**

### *PCAOB*

The proposed auditing standard requires the communications required by the proposed auditing standard to be made in a timely manner and prior to the issuance of the auditor's report.<sup>5/</sup>

### *IAASB and ASB*

ISA 260 and AU-C Section 260 require that the auditor should communicate with those charged with governance on a timely basis.

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<sup>5/</sup> The proposed auditing standard includes the following exception for registered investment companies: consistent with Rule 2-07 of Regulation S-X, in the case of a registered investment company, if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update, in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.