

## CAQ Highlights of the PCAOB's March 2011 Meetings of the Standing Advisory Group & the PCAOB Board

The PCAOB (or the Board) held a [Standing Advisory Group](#) (SAG) meeting on March 24, 2011 in Washington D.C. The SAG is comprised of individuals representing investors, public companies, the auditing profession and others and was convened by the Board to advise on the establishment of auditing and related professional practice standards. The meeting is available via [archive](#) and covered the following [topics](#), which are discussed in further detail below:

- [Update on PCAOB Developments](#)
- [PCAOB Standard-Setting Update](#)
- [FASB Presentation](#)
- [Modernization of COSO Internal Control - Integrated Framework](#)
- [Auditing Financial Statement Disclosures](#)
- [Auditor's Reporting Model](#)

Matters related to the PCAOB's Auditor's Reporting Model project also were discussed in the PCAOB's open Board [meeting](#) on March 22, 2011. The highlights below summarize the staff presentations made during both the SAG and PCAOB's open Board meeting related to the auditor's reporting model.

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### ***Update on PCAOB Developments***

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Chairman Doty provided opening [remarks](#) on PCAOB developments related to the following matters:

- Recent PCAOB outreach efforts related to potential changes to the auditor's reporting model and the March 16, 2011 [Investor Advisory Group](#) (IAG) meeting (refer to [CAQ Alert #2011-08](#));
- An increase in inspection deficiencies and focus on identifying related root causes;
- International matters including reaching accords with certain non-U.S. jurisdictions to allow PCAOB access to inspect registered firms in such jurisdictions;
- Concerns regarding the non-public nature of enforcement proceedings;
- Standard-setting efforts underway related to the oversight of broker-dealer auditors; and
- Continuing Board focus on issues related to the economic crisis.

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### ***PCAOB Standard-Setting Update***

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Martin Baumann, Chief Auditor and Director of Professional Standards, provided an update on the Office of the Chief Auditor's (OCA) standard-setting projects. Subsequent to the SAG meeting OCA intends to issue an updated standard-setting agenda that allocates additional time for certain projects. Chief Auditor Baumann attributed the need for additional time to: past experience indicating the standard-setting process often takes longer than anticipated due to the comment and review process, new Board members, the impact of the accounting standards convergence process and the time dedicated to consider any associated auditability concerns, and OCA's planned increased in the issuance of Staff Audit Practice Alerts to address audit issues identified during inspections. A CAQ summary of Chief Auditor Baumann's remarks regarding certain PCAOB standard-setting projects is provided below.

| <b>PCAOB Standard-Setting Update</b>   |   |
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| <b>Codification</b> (New)  | This is a new OCA project that will provide users with easier navigation of the professional practice standards by codifying PCAOB auditing standards (Nos. 1-15) with interim auditing standards adopted by the Board on April 16, 2003.   |
| <b>Identification of “Other Firms”</b> (New)   | This is a new OCA project undertaken in response to investor concerns regarding the lack of transparency regarding the nature and extent of the involvement of other firms in the conduct of an audit.  |
| <b>Auditor’s Reporting Model</b> (Ongoing)   | This OCA project is being implemented at an accelerated pace. OCA has conducted significant stakeholder outreach related to this project, complemented also by efforts of the IAG working group. The status of this project is discussed further <a href="#">below</a> .                                    |
| <b>Audits of Broker-Dealers</b> (Ongoing)  | This OCA project is focused on broker-dealer compliance reports required under Rule 17a-5 of the Securities Exchange Act of 1934 and will cover compliance with net capital rules and custodial safeguards. It is OCA’s intent to issue a proposed standard after the SEC issues their rule on this matter. |
| <b>Signing the Auditor’s Report</b> (Ongoing)  | OCA is currently drafting a proposal for the Board’s consideration.   |
| <b>Fair Value/Third Party Pricing Services</b> (Ongoing)                                     | OCA intends to convene an ad hoc task force of the SAG to provide further insights regarding practice issues, inform further standard-setting in this area, and assist in the understanding of root causes of frequent inspection deficiencies. The first meeting is expected to take place in May 2011.    |
| <b>Communications with Audit Committees</b> (Ongoing)  | OCA issued proposed standards in 2010 and has analyzed comments received. OCA is moving ahead with standard-setting on these proposals and will ask the Board to re-propose or adopt final standards on these matters during 2011.  |
| <b>Confirmation</b> (Ongoing)  |   |
| <b>Application of the Sarbanes Oxley Act’s Provision on “Failure to Supervise”</b> (Ongoing) | OCA issued a concept release in 2010 for comment and has decided to move ahead with a proposal for the Board’s consideration in 2011.   |
| <b>Going Concern</b> (Ongoing)   | OCA is coordinating with FASB and SEC on this project to determine whether it is necessary to proceed with PCAOB standard-setting.  |
| <b>Part of the Audit Performed by Other Auditors (Principal Auditor)</b> (Ongoing)           | OCA is currently drafting a proposal for the Board’s consideration in Summer 2011.  |

### **SAG Discussion**

At the conclusion of this session, a preparer representative expressed the importance of the Board using cross-functional forums to debate issues including those raised in the investor-only IAG.

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## **FASB Presentation**

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Lawrence Smith, [Financial Accounting Standards Board](#) member provided an [overview](#) of the re-prioritized FASB standard-setting agenda including joint and FASB-only projects and the implications of the volume and pace of proposed FASB standards (refer to related [briefing paper](#) for background). PCAOB staff sought feedback from the SAG regarding the audit implications of the re-prioritized agenda, including views regarding related transition methods and effective dates for the proposals.

## **SAG Discussion**

- An investor representative expressed the importance of PCAOB involvement in post-implementation review and expressed that pre-implementation review may be more effective. Anthony Lopez, Deputy Chief Auditor, OCA, confirmed the involvement of PCAOB staff in the FASB's post-implementation review process.
- SAG members shared the following views regarding transition methods for FASB proposed standards:
  - Preparer representatives expressed that the FASB thoughtfully consider each transition approach. Investor needs are important but should be balanced with the needs of preparers and auditors. One year of retrospective application or prospective application would be more manageable and easier for users to digest. Three years may be overly burdensome.
  - Mr. Smith noted his appreciation for the challenges associated with a three year retrospective application but noted that the user community feels strongly that retrospective application is necessary in order to ensure comparability.
  - An auditor representative recommended the FASB work closely with the SEC regarding transition approaches noting that an approach requiring three year retrospective application may actually require five years of retrospective data to be presented in certain tables within SEC filings.
- An investor representative questioned the status of the contingent liabilities project. Mr. Smith responded that the FASB will be evaluating whether the "[Dear CFO Letter](#)" issued by the SEC Division of Corporation Finance in October 2010 had an impact on the quality of contingency disclosures. This will assist the FASB in determining whether further standard-setting is required to prompt better disclosure or if existing requirements are adequate but further enforcement of the standards is necessary. Mr. Smith noted the contingency disclosure issue has largely been driven by reluctance on the part of lawyers to disclose information that would negatively impact litigation. An academic representative expressed that "Dear CFO Letters" are not a substitute for standard-setting as behavior may revert back.
- An auditor representative expressed concern that smaller audit firms and smaller companies did not provide [feedback](#) on the recent FASB discussion paper, *Effective Dates and Transition Methods*, and questioned whether the FASB would seek additional feedback given the unique challenges smaller firms and companies may face related to the volume, pace and transition requirements of FASB proposals. Mr. Smith responded that the FASB has a separate outreach effort underway to smaller firms and companies.

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### **Modernization of COSO Internal Control – Integrated Framework**

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David Landsittel, Chairman of the Committee of Sponsoring Organizations of the Treadway Commission ([COSO](#)) and Miles Everson, project team leader from PricewaterhouseCoopers (PwC), provided an overview of COSO and the project they have undertaken to modernize COSO’s internal control – integrated framework (ICIF). The overall goal of COSO’s project is to update the ICIF that was originally published in 1992. COSO has engaged PwC to lead the project under the direction of COSO and an Advisory Council.

COSO’s update of the ICIF is not intended to change the five core components that are part of the original ICIF; however, there may be changes to the application of the components that could impact how companies design, implement and test internal controls and report to regulators (e.g., SOX Section 404). COSO expects to issue an exposure draft during the latter part of 2011, with the goal of publishing a final framework during the 2<sup>nd</sup> quarter of 2012.

Key themes or areas that COSO is considering updating in the ICIF include:

- Reflecting the implication of increased use of technology and greater complexity of operational environment
- Capturing increased ethics, compliance and anti-fraud expectations
- Broadening the scope of reporting beyond external financial reporting
- Enhancing the concept of risk oversight and the role of risk assessment
- Clarifying and simplifying language
- Applying a more principles-based approach and providing a basis for evaluating deficiencies

COSO expects to issue the final update in two documents: (1) a revised overall framework encompassing reporting, operational, and compliance objectives; and (2) a companion document focusing on application of the framework to financial reporting objectives (e.g., SOX Section 404). Mr. Landsittel indicated that the guidance COSO issued entitled [Internal Control Over Financial Reporting – Guidance for Smaller Public Companies](#) will be incorporated into COSO’s update of the ICIF and therefore superseded.

With regard to governance, the updated ICIF will enhance the notion of governance as the concept applies to more organizations more broadly than as defined or inferred in the original framework. It will also incorporate lessons learned from root causes of failures in corporate governance of recent years. And lastly, it is expected that the updated framework will make more robust the discussion of “Tone at the Top.”

In the area of fraud deterrence and SOX Section 404, COSO expects:

- To expand discussion of safeguarding of assets by including consideration of fraud, misrepresentation of financial statements and corruption;
- To remain consistent with SEC suitability criteria; and
- To provide greater clarity around the basis for determining significant deficiencies and material weaknesses;

COSO also anticipates that regulators will provide any needed transition guidance to filers.

### **SAG Discussion**

Most of the comments from SAG members centered around SOX Section 404 and suggestions for improvements to the existing framework.

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### **Auditing Financial Statement Disclosures**

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Mr. Goetzler opened the discussion of auditing financial statement disclosures by noting the following:

- Disclosures have become a key component of public company financial reporting.
- The Board's [adoption](#) of risk assessment standards call for auditors to devote even more attention to disclosures.
- The purpose of raising this matter with the SAG for discussion was so that the Board could learn about the challenges that financial statement disclosure requirements – and the trends toward more qualitative disclosure and more preparer judgment concerning the content of disclosures – pose for auditors.
- The PCAOB was particularly interested in the SAG's views concerning whether there were further changes to the auditing standards needed and whether there are other forms of guidance that the Board should consider issuing in order to ensure that auditors devote proper attention to disclosures. See PCAOB's [briefing paper](#) on this topic.

#### **SAG Discussion**

- One SAG member who is both an academic and an audit committee representative expressed concern that the PCAOB might undertake a project that would lead to prescriptive auditing standards relative to financial statement disclosures. It was instead recommended that the staff consider an overall auditing framework so that the right balance is struck between all information that is reported (i.e., recognition, measurement and disclosure). It was also recommended that auditors be consistent in providing audit committees with a summary of passed disclosures including disclosures believed to be immaterial but still included in the financial statements.
- Deputy Chief Auditor Keith Wilson confirmed that the PCAOB was not intending to develop prescriptive auditing standards on financial statement disclosures; but rather wanted to address whether there are challenges associated with auditing disclosures that the PCAOB should be aware of.
- Several SAG members alluded to the fact that the “whole picture” of information in the financial statements needs to be evaluated as opposed to just the individual pieces (e.g., looking at the numbers in the financial statements separate from the disclosures).
- Several SAG members noted the International Auditing and Assurance Standards Board's (IAASB) discussion paper entitled, [The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications](#), does an excellent job addressing the challenges behind auditing financial statement disclosures. Further, it was highly recommended that the PCAOB get actively involved in the discussions with the IAASB on this matter.
- A SAG member representing the investor community suggested that the PCAOB consider the nature of each financial statement disclosure and the types of audit procedures that may be appropriate to apply to each.

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## **Auditor's Reporting Model**

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The PCAOB Deputy Chief Auditor Jennifer Rand provided a summary of the presentation PCAOB staff gave to the Board in a [public meeting](#) on March 22, 2011. She also noted that the PCAOB's [Investor Advisory Group](#) (IAG) addressed this matter at their meeting on March 16, 2011. [See [CAQ's Highlights of the PCAOB's March 2011 Investor Advisory Group Meeting](#).] The PCAOB staff's presentation to the Board summarized the staff's progress thus far on the outreach to over 80 individuals representing investors, preparers, auditors, academics, other standard setters and regulators, and others to gather views on potential changes to the auditor's report. A concept release for public comment on or about June 30, 2011 is planned, followed by public roundtable discussions in the Fall of 2011, and the issuance of a proposed auditing standard during the 1<sup>st</sup> quarter of 2012.

The following represents a summary of the feedback the PCAOB staff received from the various constituent groups. In her presentation, Ms. Rand indicated that across the board, all constituent groups believed that change to the existing auditor's reporting model was needed.

### **Feedback from Investors**

Investors expressed interest in the following information:

1. Information about the audit or what the auditor did:
  - a. What risks the auditor identified;
  - b. What the auditor's materiality assessments were;
  - c. Engagement statistics such as audit hours spent on significant areas in the financial statements; and
  - d. Auditor independence and issues discussed with the audit committee.
2. The auditor's views on the financial statements and what the auditor found such as:
  - a. Auditor's views on management's estimates and judgments, and areas of high risk;
  - b. Difficult or contentious issues; and
  - c. Auditor's views on accounting policies.
3. Additional clarification in the current auditor's report (e.g., definition of "reasonable assurance", clarity on the auditor's responsibility for detecting fraud, and the auditor's responsibility relative to disclosures in the financial statements).
4. Clarification of the auditor's responsibility or "enhanced responsibility" for information outside the financial statements (e.g., management's discussion and analysis (MD&A), non-GAAP information, earnings releases).
5. Information regarding key issues discussed between the auditor and the audit committee.

### **Feedback from Preparers, Audit Committee Members and Auditors**

The following were common themes heard from preparers, audit committee members and auditors:

1. Generally, they do not believe that the auditor should provide information that is not fact-based or is subjective in nature.
2. They expressed concerns with the auditor providing additional information that could potentially conflict with information provided by the company:

- a. It may obscure the responsibilities of management, the audit committee and the auditor if the auditor was the first public source of information;
  - b. If the auditor disclosed additional information that was not fact-based or was subjective in nature, it could potentially have a negative impact on the relationship between management and the auditor, and the audit committee and the auditor; and
  - c. There may be an increase in cost and time associated with the auditors providing such information.
3. They support the addition of clarifying language to the auditor's report (e.g., definition of "reasonable assurance", clarity on the auditor's responsibility for detecting fraud).
  4. They support referring readers to significant areas in the financial statements such as critical accounting policies or estimates by including references to management's disclosures.

### **Possible Changes to the Auditor's Reporting Model:**

Investors generally believe that the existing "pass/fail" auditor's report should remain, with the additional clarifying language added as noted above. The PCAOB staff is considering the following as possible means for the auditor to communicate additional information to financial statement users and sought feedback from the SAG:

1. **Auditor's Discussion and Analysis (AD&A)** – supplemental information to the auditor's existing report that could address the following regarding the audit and the auditor's views on the financial statements:
  - a. Auditor's identification of significant audit risk areas and the auditor's procedures associated with addressing those areas.
  - b. Auditor's materiality considerations and matters thought to bear on auditor's independence.
  - c. Auditor's views on management's judgments and use of estimates including the reasonableness of inputs and assumptions used in those estimates.
  - d. Auditor's views on the quality and acceptability of accounting policies.
2. **Auditor's Emphasis of Matters** - Expand or require the use of an emphasis of matter(s) paragraph(s) with references to the company's financial statements in specific areas.
3. **Auditor's Statement of Audit Approach** – This would consist of a discussion regarding critical judgments made in forming the auditor's opinion. The auditor's discussion could include a high level summary of the key audit procedures performed by the auditor in those areas and reference to the related disclosures in the financial statements.

*NOTE: Mr. Baumann, in his presentation to the Board on March 22, 2011 noted that the benefits of this type of communication consisting of the auditor making reference to information in the financial statements would likely improve the quality of the work the auditor performed in that area. In addition, he noted that the reference being made by the auditor to the areas in the financial statements might likely improve the quality of the disclosures of those critical areas in the financial statements. Mr. Baumann also stated that this proposed model is similar to the model being used in France.*

4. **Auditor Association with (i.e., some type of assurance on) MD&A or selected portions** (e.g., critical accounting estimates section of MD&A). This option may require SEC action.
5. **Auditor Association with Expanded Audit Committee Report to Investors** –This will likely require SEC action and could consist of providing some level of assurance regarding the completeness and reasonableness of an expanded audit committee report. It was noted that this is an option the United Kingdom Financial Reporting Council is considering.

## **SAG Discussion**

- A SAG member representing the academic community suggested that the PCAOB eliminate the 4<sup>th</sup> alternative - auditor association with MD&A or selected portions. Instead, the auditor should include in their AD&A the auditor's approach to each of the areas discussed in the MD&A (e.g., critical accounting policies, etc.). The MD&A is intended to be a discussion of the financial statements through the eyes of management and is not appropriate for the auditor to be associated with.
- Several members believed that the AD&A will eventually become boilerplate as a result of the challenges associated with operationalizing such a report. It was suggested by one academic that the PCAOB could try to avoid this by issuing implementation guidance.
- A SAG member representing the legal community indicated that auditor association improves disclosures and compliance. This person also raised the issue of cost along with several other members of the SAG, suggestion that there will be added costs associated with significant changes to the auditor's reporting model.

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*The purpose of this alert is to provide a high level summary of the PCAOB's March 24, 2011 SAG meeting and March 22, 2011 PCAOB open Board meeting on the auditor's reporting model. This high level summary was prepared by the Center for Audit Quality. Although this summary is believed to be accurate, no representation can be made that it is complete or without error.*

March 31, 2011