



CENTER FOR AUDIT QUALITY

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Highlights of the PCAOB's June 2007 Standing Advisory Group Meeting

The PCAOB held its Standing Advisory Group (SAG) meeting on June 21, 2007 in Washington, DC. The [SAG](#) is composed of 31 people representing the auditing profession, public companies, investors, and others and was convened by the Board to advise them on the establishment of auditing and related professional practice standards. The [archived web cast](#) of the SAG meeting is available by clicking on the respective link.

During this meeting, the SAG held discussions on the [following topics](#), which the Center for Audit Quality (CAQ or the Center) has summarized below:

- Accounting Estimates and Fair Value Measurements;
- Panel Discussion - Engagement Team Performance ;
- Related Parties; and
- Emerging Issues

Accounting Estimates and Fair Value Measurement

The SAG meeting commenced with discussions of fair value. The discussion was a follow-up to the SAG's September 2004 discussion of fair value which focused on the proposed revision of the existing framework for fair value measurements by the Financial Accounting Standards Board (FASB) and the potential effect of such revisions to the auditing profession.

View the [briefing paper](#) which provides an overview of issues related to auditing procedures used for accounting estimates and fair value measurements; explores whether there still is a need for two separate PCAOB auditing standards for both accounting estimates and fair value measurements; and reviews some of the similarities and differences in the auditing procedures required pursuant to the respective auditing standards.

Uncertainty Inherent in Estimates and Fair Value Measurements

Below are highlights of some commentary from the SAG meeting on the topic of uncertainty inherent in estimates and fair value measurements during which the SAG discussed how the market responds to accounting estimates and fair value measurements and whether the market responds differently to risks associated with fair value measurements as compared to other accounting estimates. Common themes that encompassed the discussion were the ability to recognize bias and the added burden on auditors as the number of estimates within financial statements increase.

- The PCAOB was applauded for raising these issues that needed to be addressed as they are timely and important. The SAG has addressed these issues before and the conclusion previously reached was that fair value estimates are just “estimates” to measure assets and liabilities.
- Two courses in valuation are not what it is going to take to educate people on fair value accounting. In the current landscape, there is an issue related to fair value specialists and that they don’t necessarily understand generally accepted accounting principles (GAAP). You need to understand fair market valuation and GAAP in that context.
- In discussions with users, it is important to be able to recognize where and how much fair value measurements are being used in financial statements.
- One fundamental piece of the comprehensive business reporting model is that fair value measurements should be used in financial statements.
- Certain questions were raised by the SAG:
 - Do or should auditors possess sufficient expertise to understand the basis for estimates and to recognize biases?
 - Do auditors possess adequate expertise to evaluate fair value?
 - Does management possess the expertise to determine fair value?
 - What happens when an auditor perceives a “bubble” to appear?
 - How robust do auditing procedures need to be in order to identify bias?
- There has always been a trade-off in financial accounting between the certainty of historic cost accounting and the immediacy and accuracy of fair value accounting.
- There may be a risk that financial statements will be seen as more arbitrary with fair value because management has even more ability to effect the financial statements.
- The more estimates that financial statements contain, the greater the burden and pressure on auditors – both internal and external auditors.

- “Fair value measurements are estimates” and the issues that arise on one, arise on the other as well.
- Education needs to be updated:
 - We need to build fair value measurements into our educational system as an early step. Also, if the firms can do likewise in their internal training and guidance, the transition will move more quickly.
 - The CPA exam currently does not test fair value measurements. That transition needs to be made if we are going to continue down this path.
 - Individuals coming into the work place need to be trained on recognizing biases with respect to accounting estimates and fair value measurements.

Auditing Fair Value Measurements and Accounting Estimates

Below are highlights of some commentary from the SAG meeting on the topic of auditing fair value measurements and accounting estimates during which the SAG discussed whether the auditor’s responsibilities for accounting estimates and fair value measurements should be combined into a single standard or whether the differences between them warrant that they continue to be addressed in separate auditing standards. Common themes that encompassed the discussion were that the auditing standards should be principles-based; how to ensure auditors are adequately educated on fair value; and the overlap of auditing standards and accounting standards.

- The key is to keep the auditing standards principles-based rather than developing rules that are prescriptive.
- However, if you combine the standards and use a principles-based approach, the principles need to be strictly enforced, because otherwise it implies deregulation and “some people will behave badly.”
- Given the similarities between the audit approach for accounting estimates and fair value measurements, it makes sense to combine them.
- Leverage the [International Auditing and Assurance Standards Board’s \(IAASB\)](#) work that estimates are estimates and the distinction is based on the level of risk and susceptibility to bias so combining them makes sense.
- Using two standards would be more appropriate because there are inherent differences between fair value and accounting estimates.
- A risk was acknowledged that if you put in only one standard, the burden on the auditors will increase unfairly when it comes to auditing accounting estimates.
- If you do combine them, you would need guidance that bridges it to accounting

guidance. It would also help if the guidance clarifies that fair value measurements are estimates.

- A question was raised to the PCAOB staff as to what they think their goal should be- to provide education on fair value or to only provide auditors' responsibilities. The PCAOB staff responded that they have considered that question and decided to stay away from educating on fair value because they want to avoid interpreting accounting standards.
- Auditing standards should not be driven by a particular accounting standard (i.e., SFAS 157, *Fair Value Measurements*).
- As a general matter, auditing standards should not address accounting issues, because auditing standards have to assume that the auditor is properly educated on the topic. While auditing standards should reinforce the point that education is extremely important for the auditor, the education should not be done in the standard itself.
- The fewer crossovers between auditing and accounting the better – auditing standards should only address auditing.
- Using a single standard for both could be supported as the auditing objectives are virtually the same and it would lead down road to convergence.
- Concern that many aren't well educated on fair value measurements and accounting estimates and so there is a benefit to having two standards.
- Educationally, there is a benefit to having two standards. It will be easier for the young people learning the rules to have two standards.
- There's also an issue on the transparency side – concern by investment community that there needs to be adequate disclosure about key assumptions and data points and increased transparency – unless the FASB provides guidance around transparency regarding key assumptions and data points.
- New recruits do not have the expertise on these matters, however the firm does not allow those individuals to make those decisions, and rather an expert from the firm is brought in. In addition, they are working to train and educate their people.
- Another possible suggestion to ensure that auditors are appropriately educated on fair value is to have the PCAOB pass a requirement that those who audit public companies have additional credentials.

Testing Fair Value Measurements and Accounting Estimates

Below are highlights of some commentary from the SAG meeting on the topic of testing accounting estimates and fair value measurements during which the SAG discussed how to determine what approach and procedures auditors should use to audit fair value measurements and other accounting estimates. Common themes that encompassed the discussion were the adequacy of the auditor's report; the use of experts; and whether management's assumptions are valid.

- One suggestion was made to use an approach similar to those used at times in the past whereby a collaboration of many constituencies was used to develop auditing standards.
- Subsequent events needs to be looked at differently because things can change from one day to next in fair value measurements, like the exchange rate related to a foreign currency embedded in a receivable or payable.
- One SAG member could not stress enough the importance of the use of experts and predicts that an increasing number of companies will be using experts in the future.
- The auditor's responsibility for experts' valuations needs to be incorporated in the auditing standards. There is much confusion in auditing standards about what the auditor's responsibilities are with respect to experts' reports.
- Another SAG member agreed that the area of experts is important – their independence, their expertise, etc., because that is becoming more important to the financial statements.
- A SAG member from the preparer side indicated that he is troubled by difficult areas of accounting like fair value being reviewed by low level, inexperienced personnel on the auditing side, when the preparer representatives dealing with these matters are experienced and at the highest levels.
- These areas should be audited based on a review of characteristics and then a framework should be drawn on where to go with procedures based on characteristics.
- A SAG member cautioned to be careful with the use of the word "additional" in describing auditing procedures for accounting estimates as it could be misinterpreted that auditors must do additional procedures. Rather, judgment should be used after working closely with management on evaluating how the estimate was developed to determine what procedures are most important.
- There was a discussion on whether more educational training requirements would demand a much higher salary. One point of view was that in other industries, further education and training is required but much higher pay does not occur, so requirements for additional training do not necessarily need to imply higher pay.

- Some issues were raised about the adequacy of the disclosures in the auditor's report and whether the auditors should communicate information regarding the extent of their procedures and what their findings were in a narrative report in order to provide some valuable information to the investors.
- A question was raised about the expertise of valuation specialists and whether there is such a thing and whether they are homogeneous. One of the risks is whether the expert even challenges the assumptions that were used by management. With respect to the requirement to communicate with audit committees about significant estimates, a question was raised as to whether there is a way to explore the effectiveness of the communication particularly as it relates to accounting estimates.
- The testing process is not where the focus should be, but rather the auditor should go to the bottom line and see whether it makes sense. So it doesn't matter how the client got to his answer but whether the answer makes sense.
- If an issuer demonstrates that they went through a fair process and that they brought in credible experts, it makes no sense to have the auditors follow a standard's rules to develop a separate approach to come up with a totally different answer. Rather, the auditor should evaluate whether the estimate is reasonable primarily for purposes of detecting fraud.
- Often clients ask the auditors to bring in their experts to make sure that management's estimates make sense.

Panel Discussion- Engagement Team Performance

With respect to the planning and supervision of the audit, the panelist presentations and related SAG discussion were intended to address:

- The level of involvement the audit partner should have in the planning and supervision of the audit engagement; and
- Whether the auditing standards should specify the audit partner's role in the planning of the audit, the staffing of the engagement team, determining the proper level of supervision of less experienced engagement team members, or other aspects of the planning and supervision of the audit engagement.

With respect to performing the audit, the panelist presentations and related discussion were intended to address:

- Whether the auditing standards should direct the senior member or members of the engagement team to be directly involved in the highest risk areas of the audit, such as risk assessment, fraud risk analysis, and other aspects of the audit that involve analysis of complex issues or the extensive use of professional judgment;
- Whether the auditing standards should define or outline specific roles for the auditors at each level of the engagement team (audit partner, manager, staff); and
- Whether special consideration should be given to audit engagements based on the size and complexity of the issuer being audited or the size of the accounting firm.

It was stated that international standards describe the engagement partner's responsibilities in much more detail with respect to the above activities.

View the [briefing paper](#) which outlines the panel discussion about whether more direction should be included in the PCAOB auditing and related professional practice standards about which members of the engagement team are responsible for performing the auditing procedures during an audit engagement.

Overview of Panelist Commentary Related to Engagement Team Performance

Below are highlights of some commentary from the SAG meeting on the topic of engagement team performance. Common themes that encompassed the discussion were the need to understand the issue with respect to engagement team performance and to specifically understand exactly "what is broken"; audit committee experiences with the engagement teams; and how an audit partner's behavior would possibly change if they were required to sign their individual names along side the firm's name.

- Should auditing standards address what engagement team members play what roles? High level: How prescriptive should auditing standards be?
- The question was raised as to whether we really want to get into prescribing what the audit engagement team members' roles should be. No two audit teams or audits are the same. The expertise of the various members can vary widely from engagement to engagement. Rather, well articulated goals should be stated.
- Flexibility is the key because small engagements might have one partner but larger engagements might have many partners and the engagement partner needs to be able to delegate in order to focus on the most critical areas.
- Is there a problem that needs to be fixed here? Is there evidence to suggest there is improper supervision, etc.? PCAOB stated that they are looking for input from the SAG to determine that. There may be no issue with the current system and if it is broken,

that doesn't bode well for the expectations that the principles-based approach is supposed to address.

- Question runs to the business model of the auditing profession as it moves toward a risk-based approach. It's not broken, but more experience needs to be brought to the table which creates a problem with the pyramid approach the firms use to train and bring people up.
- It's not broken. Any guidance should be flexible with scalability. There might be more pressure with the rotation rules, particularly with the concurring partner role. Concurring partner review standards need to be updated.
- Partners probably have more involvement in the audits than ever. There is more specificity on the concurring partner's responsibilities in the standards than the lead partner's responsibilities.
- The keys are to use a risk-based approach and to get the right experience level at each area and stage of the audit. Standards are not specific about what the audit partner should do. There is more to the standard than the responsibilities of the engagement team members - need to make sure that the appropriate people with adequate experience and seniority are assigned to the appropriate areas based on the level of risk. It is critical that the firms place quality of the audit over service development.
- One SAG member, discussed his experience as an audit committee chair with the breakdown of audit fee hours by level. While partner hours have gone up, it was not a significant drop – so while we are moving in the right direction, the partner's hours need to go up even more. When the audit partner was asked about high risk areas, the audit committee chair was referred to the audit manager, which made it obvious that the audit partner is not involved enough in the high risk areas. If the auditing standards do not ensure that firms are assigning audit areas to appropriate team members with the proper expertise level based on risk assessment, you are not going to get a top-down risk approach audit.
- The question is whether we are getting the right people on the audit? When errors are found in the filings, there are issues with the audit engagement team makeup. When you look at inspection reports, very significant deficiencies are noted. Is it an issue with performance or with the standards? What would you change in the firms' manuals?
- Audit committees are increasingly looking at the makeup of the auditing team. Audit committees need to be more vocal in getting the right engagement team makeup.
- Need to be careful on being too prescriptive on who does what. Need to think more in terms of skill set than title. This discussion would fit better as part of the quality control standards than in this area.
- Look at the inspection process to determine whether audits are being done properly

and if not, why? Then determine where additional guidance is needed.

- Performance issues are generally individual, but if a firm has something more systemically wrong, then the firm has a problem. It requires the PCAOB to determine whether this guidance belongs in the quality control or auditing standards.
- Responsibility for not following firms' policies is not just an individual performance issue but also the firm's problem too. The firm has the ultimate responsibility to ensure that its members are following its policies and the PCAOB inspection team has secondary responsibility.
- Partner needs to participate in brainstorming during the planning stage of the audit – in determining risk assessments, approach, etc.
- There may be situations where the audit manager may have better expertise to take the lead in certain areas based on experience and expertise, even though the engagement partner has the ultimate responsibility.
- In some countries, the audit partner has to sign their name along side the firm's signature. There is some belief that signing your name subconsciously holds one more accountable.
- Partners take signing the firm's name very seriously and there is no mistake who is responsible for that work. Although this may be true for most partners, the question is whether the individual signature would add that little something.
- While signing the partner's name under the firm's name would not change their responsibility for many of the partners, there may be some where it would, so it's worth exploring.
- The investors want to see the firm's name on the line.
- If we expect the officers of the company to sign their names, the auditors should be willing to sign their names too so that investors see that willingness.
- The partner has to be able to rely on the firm's quality control policies and processes.
- How can we build mechanisms for firms to handle partners so that they won't "fall off the reservation" when it comes to an engagement? Does it make sense to have audit managers sign too?
- Any quality control has a cost benefit relationship. Just like with a company's internal control system, no quality control system can provide 100% assurance from a cost benefit perspective. They build a quality control system that provides reasonable assurance that there is adequate quality control.

- There are many places in the audit work papers where all members of the engagement team have to sign. So adding one more wouldn't make a difference.

Related Parties

View the [briefing paper](#) which provides an overview of the topic of related parties including: related parties and fraud risk; understanding the company's related party transactions; known related party relationships; and undisclosed relationships.

Related Party Transactions- Market Response

The questions that were intended to be addressed with this SAG discussion were:

- How does the market respond to related party transactions? Are related party transactions perceived as having a higher risk of fraud or error?
- Absent evidence to the contrary, should transactions with related parties be considered to be in the normal course of business and carry no higher risk of material misstatement than transactions with unrelated parties?

Below are highlights of some commentary from the SAG meeting in addressing the above questions:

- "Where there is smoke, there is fire." Companies who allow related party transactions where other unrelated party transactions are available, tend to have other lapses as well. Related party transactions are usually symptomatic of other gray areas, so these are often warning signs to use greater care. From the investor point-of-view, they look at this with great scrutiny, especially in the last five years. It sends a concerning message about the tone at the top, particularly when there are other choices available.
- Generally speaking, investors see related party transactions as a red flag, because they represent a conflict of interest. There are a couple of studies that show that there are often related party transactions at companies where fraud is identified and a large percentage of those related party transactions involve the CEO and the CFO. In addition, studies show a correlation that the more frequent and the higher the value of related party transactions, the more likely there were fraudulent transactions.
- A good test for related party transactions is to talk to front managers in accounts receivable and accounts payable, etc. There are plenty of people in middle management at the front lines that are just waiting for someone to ask them about these things.

- In business, some related party transactions are unavoidable, such as joint ventures, which by definition are related parties. While those are in the normal course of business, an auditor should never assume that any related party transaction is in the normal course of business and should look into them.
- With the new Proxy rules, there will be increased transparency regarding related party transactions. It will be interesting to see the tone at the top based on these disclosures.
- Agreement that there are related party and intercompany transactions that are in the normal course of business.

Related Party Transactions- Audit Procedures

The question that was intended to be addressed with this SAG discussion was:

- Should the auditor perform procedures for understanding and identifying a company's related party relationships in every audit, regardless of the assessed level of risk? If so, what should those procedures be?

Below are highlights of some commentary from the SAG meeting in addressing the above question:

- With the electronic availability of records, there is little defense for not looking at these. So the Board should provide guidelines for auditors to meet in auditing this area because the fraud culprit is not going to tell you.
- These transactions should be given heightened scrutiny, but even more importantly, the very existence should flag the need to understand the transactions and the further implications of them.
- A risk assessment process would say that you would focus on related party transactions. However, it's not necessarily true that the existence of related party transactions automatically means that you should bring in a forensic team because that's not always the case.
- If you look at the issues where these were most problematic like Enron - people knew about the transactions, the auditors knew about them – you need to go further than inquiry of management, because that isn't enough in these cases. It's about doing other things to understand what the transactions are and what their business purpose is. And if the auditor doesn't get that understanding, they are going to miss the boat. Any standard should say that related parties should create heightened awareness and skepticism – otherwise there is a problem.
- Should there be more prescriptive requirements in the standards?

- It's all about adjusting your risk assessments appropriately rather than developing prescribed auditing standards. If you start making it rules-based vs. principles-based, you're going to have people doing a checklist approach with little return on investment.
- It might be helpful to give auditors an idea of what the thought process should be when considering these transactions and whether they are material and unusual.
- The intersection of related parties and materiality under SAS 99 should be considered.

Related Party Transactions that Pose a Higher Risk

The question that was intended to be addressed with this discussion was:

- Are there specific types of related party relationships or transactions that pose a higher risk? If so, should the auditor perform additional procedures?

Below are highlights of some commentary from the SAG meeting in addressing the above question:

- Look at client's internal controls and those controls that are inherent to controlling.
- There is no way to ensure that you will find a problem no matter what.

Undisclosed Related Party Transactions

The questions that were intended to be addressed with this discussion were:

- To what degree should the auditor be expected to search for and identify undisclosed related parties and related party transactions?
- Are there certain procedures the auditor should perform in each audit, or should the auditor be expected to determine those procedures based on the assessed risk of undisclosed matters? If based on risk, how should the auditor be directed to assess the risk of undisclosed related parties and related party transactions?

Below are highlights of some commentary from the SAG meeting in addressing the above questions:

- There are times when Wall Street finds the related parties and the auditors do not. The auditors do not do the types of analyses that analysts do. Reach out to Wall Street to find out what they are doing to catch these transactions that the auditors do not catch. It's likely because the auditors are only looking at what is right in front of them and not out on the internet, etc.

- It is important to get auditors to think out of the box (e.g., Google on the internet, etc. – look for relationships and transactions).
- Auditors need to engage general counsel and outside counsel in a more robust way.
- How can a list of related party transactions be used to identify other issues?
- Seeing more companies using related parties to write off assets and the like. A question came up regarding the reporting requirements – when the related parties are pervasive and large in number, one might wonder whether the financial statements can be relied upon?

Emerging Issues

Some emerging issues that were raised and briefly discussed were: the recent signs of crisis in the subprime mortgage market and suggestions for the PCAOB's standards-setting priorities for next year.

Marty Baumann, the PCAOB Director of the Office of Research and Analysis, led a discussion regarding the warning signals coming out of the subprime mortgage market. The following are some highlights of the commentary from the SAG meeting in addressing this issue:

- Much of the recent volatility in equity markets has been attributed to softness in the subprime mortgage market and concerns that those exposures could spill over to the broader credit markets.
- The second largest subprime mortgage lender just went out of business. In addition, losses on subprime investments are growing.
- Two questions raised were – (1) to what extent the troubles in the subprime mortgage market will carry over into the lending market as a whole; and (2) what advice would you give to auditors as to how they should react to these significant dangers and threats?
- A parallel was drawn to the savings & loan (S&L) crisis of the 1980's in that the banking regulators and certain Congressional representatives are again starting to put pressure on the auditors and regulators to provide accommodations in the accounting rules so that the reality doesn't have to be shown on the financial statements. It was urged that we can't let this happen or we'll have the same problem again.
- How are issuers and auditors dealing with the sometimes differing interpretations of guidance issued by banking and securities regulators regarding loan loss reserves?

The following suggestions were made with respect to the PCAOB's standards-setting priorities for next year:

- A question was raised as to how long the bulk of the PCAOB's standards are going to remain "interim standards," particularly given that that the PCAOB has now been in existence for five years.
- Further guidance is still needed on the confirmation process.
- A recommendation was made that a comprehensive analysis of the inspection reports to date should be developed to show where there are standard problems vs. performance problems. This would help the Board focus its standard-setting agenda. To view the [Center's analysis of the PCAOB inspections reports](#), click on the respective link.
- The fraud standard.
- It was pointed out that AS 2 and AS 5 will continue to be an issue in the coming year.
- It was suggested that the PCAOB may want to look to the IAASB and even the Auditing Standards Board (ASB) priorities for some alignment on what they are both looking at in the coming year.

Additional Information

The complete [agenda and briefing papers](#) for this SAG meeting can be accessed by clicking on the respective link.

To view a compilation of past SAG topics and corresponding briefing papers discussed by year, visit the [CAQ SAG Topics and Briefing Papers Web Page](#)

For information regarding past SAG meetings and SAG members, visit the members' only section of the [CAQ – PCAOB Standing Advisory Group Web Page](#).

For information on auditing related parties, access the AICPA's [Related Party Toolkit](#).

Stay Informed

As a member of the Center, your firm will receive periodic updates on important developments related to the PCAOB and the SEC, as well as the activities of the Center, particularly with respect to the

submission of comment letters on PCAOB and SEC proposals. To stay abreast of these and other relevant events in public company audit practice, please visit the Center Web site at theCAQ.aicpa.org. Also, we welcome any suggestions or questions - please send them by email at Center@theCAQ.org.

Sincerely,

Lillian Ceynowa, CPA
Center for Audit Quality
Director of Professional Practice & Member Relations
(212) 596-6084
lceynowa@theCAQ.org

Jeanne Parsons, CPA
Professional Practice &
Member Relations
(212) 596-6124
jparsons@theCAQ.org

— Annette Schumacher Barr, CPA
Professional Practice &
Member Relations
(202) 609-8062
aschumacher@theCAQ.org

—
Kellie Sclafani, CPA
Professional Practice &
Member Relations
(212) 596-6065
ksclafani@theCAQ.org

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AICPA, 1211 Avenue of the Americas, New York, NY 10036

Center for Audit Quality
601 13th Street NW, Washington, D.C. 20005

