



CAQ Alert #2007-56 – October 24, 2007

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DEAR CENTER MEMBERS

Highlights of the PCAOB's October 2007 Annual Standing Advisory Group Meeting

The Public Company Accounting Oversight Board (PCAOB or the Board) held its annual Standing Advisory Group (SAG) meeting on October 18, 2007 in Washington, DC. The [SAG](#) is composed of 30 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 [SAG meeting webcast](#) is available online.

During this meeting, the SAG held discussions on the following topics (View [PCAOB SAG agenda](#) online):

- Proposed Standards-Setting Activities
- Audit Implications of International Financial Reporting Standards (IFRS) Financial Statements in U.S. Securities and Exchange Commission (SEC) Filings
- Office of Research and Analysis, Working Paper Presentation – Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era

Proposed Standards-Setting Activities

Tom Ray, PCAOB Chief Auditor, Director of Professional Standards and Chairman of the SAG, started the meeting by outlining the PCAOB's significant standards-related accomplishments since last year's [annual SAG meeting](#). He also proposed the new standards-setting priorities for the coming year. The following outlines Mr. Ray's comments regarding these matters:

ACCOMPLISHMENTS

- **Internal Control Over Financial Reporting**
 - AS 2 Revision – [Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements \(AS 5\)](#)
 - [PCAOB staff guidance](#) on auditing internal control over financial reporting in smaller public companies (issued 10/17/07 for 60-day comment period). Please refer to [CAQ Alert 2007-55](#) for CAQ's summary of the guidance).
 - PCAOB Office of the Chief Auditor (OCA) had considerable interaction with the PCAOB Inspections Division as they were involved with each step of the AS 2 revision project. OCA will remain involved in the development of the inspections approach and is participating in the development and delivery of inspections training on the new internal control auditing standard. OCA staff also assists the inspectors in evaluating inspections findings and in communicating those findings to the registered firms.
- **Principles of Reporting**
 - Proposed Auditing Standard on [Evaluating Consistency of Financial Statements](#) (April 3, 2007)
 - Proposed Amendments to [Interim Auditing Standards](#) (April 3, 2007)

The comment period on these proposals ended in May 2007 and the PCAOB staff (Staff) is working to complete the revisions to the proposals based on the comments.

• **Independence and Prohibited Services**

- [Concept Release Concerning the Scope of Rule 3523](#), *Tax Services for Persons in Financial Reporting Oversight Roles* (April 3, 2007)
- [Proposed Amendment to Rule 3523](#), *Tax Services for Persons in Financial Reporting Oversight Roles* (July 24, 2007)
- [Proposed New Rule 3526](#), *Communication with Audit Committees Concerning Independence* (July 24, 2007)

The comment period on these proposals ended in September 2007 and the Staff is working to complete revisions to the proposals based on the comments.

• **Other Accomplishments**

- [Staff Questions and Answers](#) – *Auditing the Fair Value of Share Options Granted to Employees* (October 17, 2006)
- [Staff Questions and Answers](#) – *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* (April 3, 2007)
- [Rule 4010 Report](#) – *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (January 22, 2007)
- [Rule 4010 Report](#) – *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (April 18, 2007)

PRIORITIES AS OF OCTOBER 2007

Mr. Ray indicated that he expects that “some, and not all, of the following items will result in either proposed or final adopted standards or rules during the next twelve months.”

- **Internal Control** – effective implementation of the internal control reporting provisions of the Sarbanes-Oxley Act will continue to be a focus of the PCAOB
- **Independence and Principles of Reporting** – they plan to complete the projects on the proposed standards and rules that were previously exposed for comment as noted above
- **Engagement Quality Review** – The SAG has discussed engagement quality reviews on two separate occasions:
 - [October 5-6, 2005 SAG Panel Discussion](#) – Engagement Quality Reviews in Smaller Registered Firms
 - [November 17-18, 2004 SAG Meeting](#) – Potential Standard – Elements of Quality Control
- **Risk Assessment, including fraud risk assessment** – Staff is reevaluating the auditor’s risk assessment process, which includes the auditor’s understanding of the company he or she is auditing and the company’s environment, the auditor’s assessment of the risks of material misstatement of the financial statements, and the linkage between the assessed risks and the nature, timing, and extent of the auditing procedures performed in response to those risks. Mr. Ray indicated that they are evaluating the work of the two auditing standards-setting boards (International Auditing and Assurance Standards Board (IAASB) and the U.S. Auditing Standards Board (ASB)) that have revised their auditing standards to enhance the auditor’s risk assessment process.
- **Fair Value** – They have been evaluating the existing auditing standards on auditing estimates, auditing fair values, and using the work of specialists to determine whether any changes to the Board’s standards or additional staff guidance are needed.

- **Specialists** – They will reevaluate the auditor’s use of specialists, either when a company engages or employs a specialist and the auditor uses that specialist’s work as evidential matter in performing an audit, or when the auditor engages a specialist and uses that specialist’s work as evidential matter. The PCAOB is monitoring the IAASB’s and the ASB’s projects in this area and will consider their results.
- **Related Parties** – They plan to include the consideration of fraud risk and will reevaluate the auditor’s obligation for the identification and evaluation of related parties and related-party transactions, and consider what direction is needed to help auditors satisfy that obligation.
- **Confirmations** – They will reevaluate the auditor’s use of confirmations to corroborate a company’s account balances and transactions directly with third parties.
- **Action Plan for Review of Interim Standards** – The Board indicated upon adoption of the existing April 2003 auditing standards of the AICPA that it would establish a schedule and procedure for the review of all the interim professional auditing standards. Mr. Ray indicated that they have not yet established such a schedule or procedure; rather, they plan to focus their standards-setting resources on specific priorities, which is consistent with the advice they have received from the SAG in the past.

OTHER MATTERS AFFECTING PRIORITIES

- **Global Auditing Standards** – Questions are being raised about the need for uniform auditing standards for both domestic and cross-border financial reporting purposes. Mr. Ray indicated that he expects to seek the SAG’s advice on whether there is a need for a set of globally accepted auditing standards, how the PCAOB should interact with the other auditing standard setters, and how this should fit within the PCAOB’s other priorities.
- **XBRL** – As this initiative develops, the Staff will be working closely with the SEC to address auditors’ responsibilities with regard to XBRL-tagged data.
- **Federal Advisory Committees** – Recommendations from these committees might affect PCAOB priorities:
 - [SEC Advisory Committee on Improvements to Financial Reporting](#)
 - [U.S. Department of the Treasury Advisory Committee on the Auditing Profession](#)

Below are highlights of some of the commentary from the SAG members:

- Recommendation that the PCAOB consider an overall framework for international convergence.
- Applaud PCAOB for acknowledging the international aspects underway and look forward to knitting all of the standards (both accounting and auditing) and governance structures together as more corporations become more global.
- The Board should consider obtaining broad input on which direction to head regarding international convergence. One option would be to use the International Standards on Auditing (ISAs) as a starting point when promulgating U.S. auditing standards.
- The PCAOB standards-setting staff was asked if they have benchmarked their size against the size of other auditing standards-setting organizations. The voluntary time devoted by the accounting profession to other auditing standards-setting bodies might exceed the resources and size of the standards-setting group of the PCAOB.
- Surprised that we don’t have an overall priority, framework, or overarching principle that would at least be on a path for global auditing standards similar to the accounting side of convergence.
- Mr. Ray indicated that the PCAOB Staff’s participation as observers at the IAASB meetings has been very insightful. He also indicated that when taking on a standard setting project, they start by reviewing what the IAASB and ASB have done.
- Agreement was expressed regarding XBRL and the type of role an auditor should play when associated with it (i.e., either to provide assurance or to perform other procedures).
- Fair value and use of specialists should be at the top of the list. There should be a future educational SAG session on what the differences are between the PCAOB auditing standards and the international auditing standards so that the SAG members can properly advise the Board and

its Staff. The Board should start with a clean sheet of paper in developing auditing standards that includes more flexibility to allow the auditor to eliminate certain procedures that may not be necessary.

- John White of the SEC's Division of Corporation Finance indicated that a rule making proposal for XBRL will be made in the Spring of 2008 with the possibility of the adoption of a rule mandating the use of XBRL by U.S. filers in the Fall of 2008. "What has to be filed [with the Commission] is the question." An attestation standard would be one choice to increase the reliability of the XBRL data.
- It is critical that the Board assert that it is the standards-setter for auditing standards in the U.S. The Board was strongly urged to take up the authority that it has.
- PCAOB should be commended for getting through what was a very tough standard (AS 5), which is viewed as an effective standard. Not surprising that other things have fallen behind. Priorities are right on target, however fair value needs to get more attention.

View [Mr. Ray's script](#) for the standards-setting agenda topic.

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Audit Implications of IFRS Financial Statements in U.S. SEC Filings:

Below are highlights of some of the commentary from the SAG meeting on the topic of the U.S. GAAP reconciliation, the requirements of [Appendix K](#) – SEC Practice Section (SECPS) Member Firms with Foreign Associated Firms that Audit SEC Registrants (PCAOB's interim quality control standard adopted on April 16, 2003), and the audit implications of allowing U.S. issuers to adopt IFRS in the following areas: a) evaluation of the fair presentation; b) auditor education; c) implications related to a firm's system of quality control; d) transition to IFRS by U.S. issuers; and e) market implications to auditing firms. View the [briefing paper](#) on this agenda item.

Appendix K Requirements:

- The oversight process has changed since the adoption of the Appendix K requirement in 1999 by the SECPS in that non-U.S. registered firms are directly inspected by the PCAOB to ensure that audits are being properly completed in accordance with PCAOB standards.
- Eliminating the Appendix K requirements to the extent there is no U.S. GAAP reconciliation makes sense.
- The SEC requires a positive assertion from the auditor stating that he or she complied with U.S. auditing standards whereas in the past the auditors were allowed to express opinions indicating that the audit was done in accordance with auditing standards that were substantially similar to U.S. auditing standards.
- To the extent there is valuable information to investors in Appendix K, it would be unfortunate to lose it if it were eliminated.
- The number of foreign private issuers has decreased over the last number of years and that needs to be taken into consideration.
- We still support the inspection procedures of Appendix K even in a world with a U.S. GAAP reconciliation.
- Appendix K was a good mechanism to promote consistency in audits but to suggest that audit quality overall has improved because of it may be a bit of an overstatement.
- To the extent that the Board makes a country-by-country decision on where to rely on that regulators' inspection processes where it is robust makes sense. However, to the extent there are certain countries where the regulator inspection process is not as robust, it would seem that the PCAOB would be doing more inspections and it raises the question as to whether the PCAOB has the resources to handle this.

- The internal inspection process by the firms of foreign affiliates as currently required by Appendix K should be more robust than it is here in the United States.
- Appendix K was designed to require the firms to put a “gatekeeper” in place. Appendix K does give investors in the U.S. some assurance. There have been problems with the implementation of the standards. For example, Japan closed down a firm because of poor quality. There are even questions as to whether they are following the independence rules. There are questions as to whether we should turn this over to the specific countries to regulate/inspect. If you take the gatekeeper requirements in Appendix K out, then you may be back to where you were when Appendix K was originated unless you have a good functioning quality control system in place to ensure that quality audits are getting done right and that people are held accountable.

Possible Transition to IFRS by U.S. Issuers: Market Implications to Auditing Firms, Evaluation of the Fair Presentation, Auditor Education, and Implications Related to a Firm’s System of Quality Control

- IFRS is much more judgment based and we will be in a much less definitive place for deciding what the right answer is (e.g., “my judgment vs. yours”). There is general support to live in that space, however, many are ill-prepared to live in that world. As an auditor it will significantly change how they interface with their client.
- There is a dilemma in the way things are done today in that management certifies the fair presentation of the financial statements. They do not certify that they are in conformity with U.S. GAAP; whereas auditors’ opinions go to the fair presentation in conformity with U.S. GAAP. As a result, there already exists a difference between what is required of management by the SEC and what is required of auditors in the auditing standards. The more different the reporting standards, the more difficult it will be to determine what is fairly stated and what is fairly stated in conformity with “what?”
- IFRS will change behavior and culture. Analogy was presented that interpretation of IFRS is similar to “goal posts.” There are things that go to the right and to the left of the “goal posts” given a certain set of facts and circumstances. People will need to be true to the principles and there will need to be understandability and transparency. Then there are places where you are outside of the “goal posts.” Preparers and auditors are going to need to understand where those goal posts are to make sure we are protecting investors.
- IFRS has disclosure requirements on going concern whereas U.S. GAAP does not. The Board would need to revisit the going concern auditing requirements.
- The biggest issue for auditing standards is that the audit reports are referenced as being prepared in accordance with IFRS but which version of IFRS would it be? There could be potential user confusion on which version of IFRS was used.
- Are the “goal posts” wider under IFRS than under U.S. GAAP? Is there more evidence of earnings management under IFRS than there is under U.S. GAAP? - which may get at the width of the “goal posts.”
- The SEC has long had a rule that says if there is material information that isn’t captured by another rule or principle, you can’t avoid it just because there isn’t a rule on the books to account for it. When PCAOB looks at AU Section 411.04, they should consider adding the requirement that the SEC has on their books to capture situations when there is other information that is material to the financial statements but not required by a particular rule, it should be required to be accounted for and disclosed.
- Cost of gearing up to teach IFRS for colleges and universities is quite significant. Unless the CPA exam is changed, you put faculty in an uncomfortable position because students, parents and taxpayers expect students, when they graduate, to pass the CPA exam and until the exam starts to test for IFRS, the schools will not teach it.
- Students are required to take a set number of course hours. If you put an IFRS course into the curriculum, what is coming out and what are we not teaching them? If people want widespread adoption, it does help to have these curriculum materials available as they are not today. Another issue is that faculty will need to be trained. There appears to be a small number of students who will really need to know IFRS, as most students may not use it in their professional careers. Should IFRS be taught at the universities or by the public accounting firms?

- It is critical that the PCAOB have a view on whether the accounting profession is in a position to: (1) discharge its auditing responsibilities if the SEC's recent concept release turns into a rule proposal; and (2) be able to communicate that position to the SEC.
- If the colleges or the universities are not going to be teaching IFRS, they are going to be graduating students that are not current on the needs of the business world.
- It sounds like we are talking about "taking accountants and turning them into neurosurgeons. IFRS and U.S. GAAP is accounting which is not all that difficult." Taking one set of accounting standards and going to another set of accounting standards is not too difficult. The "bridge" here in the U.S. is much shorter than the "bridge" traveled by other countries. The key is to develop a reasonable plan that takes into account the needs of preparers and auditors to get to the point where our market place can absorb the use of IFRS. It also needs to take into account the educational system.
- With regard to the system of quality control, the accounting firms have a basic business decision to make in terms of their audit practice in a world where you have IFRS and U.S. GAAP. Do they have staff where they bifurcate the two disciplines or where the staff is "bilingual" such that they can crossover between both IFRS and U.S. GAAP. There are pros and cons to both. If there were two silos then the quality controls would exist in both.

Board member Kayla Gillan asked the public accounting firm representatives on SAG whether any firm is contemplating taking a position to not provide these services to U.S. issuers as it relates to IFRS.

- A large firm representative answered that they would continue to serve those clients. A smaller firm representative who is with a firm that has approximately 400 people indicated that they already are doing IFRS work now.

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Office of Research and Analysis (ORA), Working Paper Presentation – Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era:

Below are highlights of some of the commentary from the SAG meeting on the Office of Research and Analysis presentation on studying Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era. This paper was an offshoot of other work that the Office of Research and Analysis was doing. View the [briefing paper](#) on this agenda item.

- The research attempts to address a question of whether investor confidence changed in the post-SOX era. This is a difficult question to address. It is hard to think of using restatements to address market reaction. There is a lot of literature that discusses the many variables that go into market reaction. The PCAOB staff was asked to take into consideration these variables and apply them to their research results, as it did not appear that these factors were controlled for in this study.
- This is quite relevant to other variables of things going on with market reaction. This study would seem to suggest a theory that under the pre-SOX era where restatements were unusual, investors would tend to view a restatement as a catastrophe and that in the post-SOX era that perception has diminished.
- To the extent that PCAOB is looking at reasons for the downward trend since Sarbanes-Oxley – the PCAOB may want to note the SEC changed the Form 8-K rules.

PCAOB chief economist indicated that they have started reviewing the topic for discussion purposes so that other experts may latch onto it and answer the questions. It was never the intent of the Staff to be the experts on this topic

Emerging Issues – Subprime Mortgage Crisis and Illiquidity in the Markets

Several SAG members suggested that the PCAOB do an update on emerging issues discussion that took place since the last SAG meeting in June 2007.

Chairman Olson indicated that they talked about the subprime mortgage issue at the last SAG meeting as the issue was just starting to emerge and in the intervening months has become a major issue. The PCAOB wanted to take this time to educate the SAG on some of the accounting and auditing implications that they have been following.

Marty Baumann provided an update of the activities since the last SAG meeting in June 2007 as follows:

- The subprime mortgage crisis led to a larger liquidity crisis and to the identification of the risks of some investment vehicles that some may not have really understood existed (e.g., structured investment vehicles)
- PCAOB has been actively discussing these risks at regular meetings called the *PCAOB Audit Risk Working Group* meetings. These meetings include PCAOB staff, senior technical partners of the 8 firms that are annually inspected by the PCAOB, and senior staff of the Center for Audit Quality.
- The PCAOB has also participated in conversations with the accounting firms, SEC staff, FASB, and banking regulatory agencies.
- PCAOB inspection teams have considered these risks in their inspections of 2006 audits taking place in 2007 and in planning for the 2008 inspection cycle.
- The accounting profession through the Center for Audit Quality issued [3 white papers](#) intended to interpret existing GAAP with respect to certain of the accounting issues highlighted by the current market conditions.

These are extremely complex accounting issues with which preparers and auditors have had to deal. Overall, the PCAOB is closely monitoring the current market conditions that create an environment of elevated accounting risk. The PCAOB will issue additional audit guidance if they believe it is needed.

The PCAOB was encouraged by a SAG member to meet with the credit rating agencies to determine what they need that they aren't already getting.

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SAG Chairman's Wrap-Up

Mr. Ray closed the meeting by thanking the SAG members. He also indicated that the new SAG members will be announced at the end of the month and that he wanted to thank those members who have just completed a turn and for those who will not be returning.

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](#)

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