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CPCAF Summary of PCAOB February 9th Standing Advisory Group (SAG) Meeting

The Public Company Accounting Oversight Board (PCAOB or the Board) held a Standing Advisory Group (SAG) meeting on February 9, 2006 in Washington, DC. The PCAOB sought advice of its SAG members on topics for consideration as possible auditing and related professional practice standards. The SAG meeting has been archived and is available by clicking on the following link: http://www.pcaobus.org/News_and_Events/Webcasts.aspx.

The PCAOB opened up the SAG meeting by stressing the vital role that the SAG plays in the Board's standard setting activities and Thomas Ray, the new Chief Auditor of the PCAOB and Chair of the SAG, represented his commitment to the SAG at this first meeting as Chair. Mr. Ray welcomed all the SAG members and introduced the 17 new members. It was noted that John White, who would have made the 18th new SAG member was recently appointed as the new Securities and Exchange Commission (SEC or Commission) Director of Corporation Finance, and therefore, would not be serving on the SAG. Refer to the Center for Public Company Audit Firms Summary of the PCAOB SAG Members for additional information regarding the new and old SAG members by clicking on the respective link.

The Board briefly discussed the recent SEC approval of Auditing Standard No. 4 – Reporting on Whether a Previously Reported Material Weakness Continues to Exist and indicated that this was an example of a project that was not on the list of standard setting activities, however, it was taken up because of the advice of the SAG and the apparent importance that it had to the profession and to the U.S. capital markets.

The following is a high level summary prepared by the staff of the Center on the topics that were discussed during the one day SAG meeting on February 9, 2006:

Using the Work of a Specialist: View the briefing paper that served as the roadmap for this discussion. The briefing paper outlines the auditor's use of specialists in performing an audit; current issues in applying existing auditing standards; and the discussion questions that were posed to the SAG members for feedback regarding appropriate auditor responsibilities related to the role and the use of specialists.

Jennifer Rand, PCAOB Associate Chief Auditor, and Greg Fletcher, PCAOB Assistant Chief Auditor, moderated this discussion and the basis of the discussion was the current interim auditing standard on specialists, AU Section 336, Using the Work of a Specialist. The use of specialists has been on the Board's list of 2006 standard setting activities and has been linked to the standard on auditing fair value, however, the Board determined that it was in the best interest of all to focus specifically on other uses of a specialist and to have a broader discussion of the topic to determine whether this should be a separate standard setting project.

The following language represents various discussion points that were made during the SAG meeting and are for informational purposes only.

1. **Auditor Competencies and the Need to Use Specialists —** Discussions were held regarding what the auditor's expertise and competencies should be; when it is appropriate to rely on a specialist; the types of future skills that will be needed by auditors; and whether the auditor's procedures to evaluate the work of a specialist should vary depending on whether the subject matter is in an area only partly beyond the auditor's competence (i.e., valuation of complex financial instruments) or in an area requiring entirely different skills and knowledge (i.e., geology).

   Some SAG members indicated that there is a large amount of complexity in the accounting and auditing environment today and not one person should have the expertise in all of these areas; however, baseline knowledge of these areas is appropriate. Consideration should be given to the credentials of specialists; the authoritative guidance that exists on testing the underlying data of specialists; the independence factor; and what the purpose of a specialist is and why they are engaged.

   There is a need to look at the educational preparation for those entering the accounting/auditing profession. Some areas that were mentioned that future auditors will need much more knowledge on were: the ability to read contracts; foreign cultures and business practices; industry knowledge; information technology; and fair value. Certain SAG members believe that there needs to be a major policy change in the classes that undergraduates take to learn these competencies and skills and it would not be useful to give auditors more responsibilities without providing the appropriate match of education.

2. **Specialized Skills in Accounting and Auditing —** Discussions were held regarding whether the auditing standards should provide more specific guidance for planning, overseeing, and evaluating the work of professionals with specialized skills or knowledge in accounting or auditing, or should those professionals be included within the scope of a standard on specialists.

3. **Using the Specialist's Work —** Discussions were held regarding whether the procedures described in AU 336 are adequate for evaluating the work of a company's third-party specialist, an employee specialist of the company, or the specialist engaged or employed by the auditor. In addition, the SAG members discussed whether the auditor should have responsibility to directly evaluate the reasonableness of the methods and assumptions of the company's specialist and if an auditor uses his or her own specialist to help in evaluating the work of the company or its specialist, how should the auditor evaluate the finding of his or her own specialists. The discussion touched upon the adequacy of AU 336 and whether it is too low; too high; the need for

more guidance; the possible need to look at the definition of a specialist; and whether there is ambiguity as to the auditor's role.

4. **Independence and Objectivity Considerations —** Discussions were held regarding whether the auditor should consider the objectivity of a specialist who is an employee of the company differently from the objectivity of a specialist who is a third-party contractor of the company; whether there should be a requirement that the auditor and the company under audit not engage the same specialists; and whether the standard should provide additional guidance for the auditor on evaluating the objectivity of his or her third-party specialist. There was a discussion regarding the fact that specialists are not required to be independent as the auditors are; what independence standards should the specialist be upheld to; would stricter independence requirements limit the pool of specialists to choose from; freedom from conflict on the specialist's part; and would the auditor be responsible to make sure that the specialist is independent.

Review of Risk Assessment Standards - The Auditor's Consideration of Materiality in Audit Planning and Evaluation of Likely Misstatements: View the briefing paper that served as the roadmap for this discussion. The briefing paper discusses risk assessment; the auditor's consideration of materiality; the use of professional judgment and skepticism; and the need for evaluation of qualitative and quantitative factors in obtaining reasonable assurance that the financial statements are free of material misstatement.

Keith Wilson, PCAOB Associate Chief Auditor, and Bella Rivshin, PCAOB Assistant Chief Auditor, moderated this discussion and the primary basis was AU Section 312, Audit Risk and Materiality in Conducting an Audit. The Board discussed the fact that this topic has been evolving over the past year and there are new issues that needed to be discussed amongst the SAG for consideration, particularly, the notion of materiality.

1. **Consideration of Materiality in Planning the Audit —** There was a discussion on whether the auditing standards provide direction on the use of financial benchmarks in determining planning materiality. SAG members suggested to the Board to see if there is the possibility to create some synergy amongst the standards of other standard-setters, such as the AICPA or FASB in this area.

2. **Consideration of Planning Materiality at the Account and Disclosure Level —** There was a discussion on whether the auditing standards require auditors to specify tolerable misstatement for significant accounts and disclosures and whether embracing materiality for the financial statements "as a whole" was embracing too much or if materiality should be considered in respect to certain aspects such as net income or net assets.

3. **Adjustments of Audit Scope Overall —** There was a discussion on whether the auditing standards provide direction about when to consider adjusting the audit scope overall and an emphasis on the fact that this is a fundamental part of the audit process. A question was raised that if there is a need for more guidance specific to this, then it brings into question the entire audit process.

4. **Sample Sizes in Substantive Audit Sampling —** There was a discussion on whether, in a substantive audit sampling procedure, the sample size that is determined using a nonstatistical sampling approach be comparable to a well-designed statistical sample size using equivalent parameters and the flexibility that auditors have in determining sample sizes.

5. **Evaluation of Likely Misstatements —** There was a discussion on whether it is sufficient in the auditing standard to state that "Management responses… should ordinarily be corroborated with other evidential matter", or should the auditing standards provide more direction regarding what and how much auditors should do to corroborate management's explanations for significant unexpected differences. SAG members agreed that corroborative evidence to support management's response should always be sought. SAG Members also discussed whether it is appropriate for an auditor to treat uncorroborated differences as likely misstatements and the consensus was that this may constitute a scope limitation instead.

6. **Evaluation of Accounting Estimates —** There was a discussion on whether the auditing standards require auditors to quantify and evaluate the differences resulting from testing accounting estimates, including differences that fall within a reasonable range, and consideration was given to the idea that maybe the size of the range should be tightened as the ultimate purpose of a range is to have defined parameters.

7. **Precision of Auditor Judgments about Accounting Estimates —** There was a discussion on whether the auditing standards should provide more direction regarding the precision of the auditor's judgments about accounting estimates and whether the ranges within accounting standards versus auditing standards should be looked at.

8. **Consideration of Management Bias in Accounting Estimates —** There was a discussion on whether the auditing standards should provide more direction on how to evaluate the possibility of management bias in accounting estimates and its effect on the financial statements. It is also important to look at the frequency of changes in accounting estimates between periods.

Emerging Issue- The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters: View the briefing paper that served as the roadmap for this topic. The briefing paper discusses the possible effects of litigation-related clauses in audit engagement letters with a focus on how these clauses relate to independence and objectivity of the auditor; background information about the existing independence guidance; new proposals currently under consideration by other standard-setting bodies; and the types of litigation-related clauses that are currently used.

Bella Rivshin, PCAOB Assistant Chief Auditor, moderated this topic and explained that there are many issues related to this topic and there have been recent developments from the following parties:

- February 2006: The Federal Financial Institutions Examination Council (FFIEC) issued an *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Engagement Letters* which can be accessed at http://www.ots.treas.gov/docs/4/480217.pdf. **Appendix B** to the briefing paper includes information on the FFIEC proposed interagency advisory that was recently finalized and discusses the safety and soundness implications of provisions that limit the external auditor's liability in a financial statement audit.

- September 15, 2005: AICPA issued a Proposed New Interpretation, 101-16 under Ethics Rule 101- *Indemnification, Limitation of Liability and ADR Clauses in Engagement Letters.* **(Appendix C to the briefing paper).** Click here for additional information on the AICPA's Proposed Interpretation.

In addition, the appendices to the briefing paper also included the following:

- SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions, Other Matters- Question 4, regarding the Commission's view that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question.
- AICPA, Code of Professional Conduct, ET Section 191, *Ethics Rulings on Independence, Integrity, and Objectivity,* "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters."

The discussion touched upon the various different types of indemnification and limitation of liability clauses such as:

1. Auditor indemnified against claims based on auditor's negligence;
2. Auditor indemnified against claims based on knowing misrepresentation by audit client's management;
3. Auditor indemnified against claims based on audit client's negligence;
4. Auditor's liability limited to the amount of fees paid;
5. Limitation of period during which audit client could otherwise file claim;
6. Limitation on audit client's right to assign or transfer claim; and
7. Exclusion of punitive damages.

Generally, SAG members agreed that indemnification clauses in engagement letters are not appropriate and in fact may be prohibited by the SEC. As a result, the question was raised as to why the SAG and the PCAOB would consider this.

Further, some SAG members also cited the fact that engagement letters do not drive the conduct of the audit and that there are a number of processes in place that require auditors to conduct a high quality audit therefore, believing that litigation-related clauses would not have an impact on independence or objectivity. In addition, some SAG members indicated that the auditor should discuss the details of such litigation-related clauses in the engagement letter with the audit committee.

It was also suggested that the PCAOB should review the engagement letters during the inspection process to determine whether the audit was conducted at lesser quality based on the litigation-related clauses contained in an engagement letter.

SAG members suggested the need to look at these clauses separately because some may compromise independence and objectivity and others may not; however, there was a request by SAG members for the need for more factual information to see what types of situations exist in the current environment before they can move forward with this topic and determine the effects on auditor independence.

Additional Information

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

For information regarding past SAG meetings, visit the member's only section of the Center for Public Company Audit Firms - PCAOB Standing Advisory Group Web Page by clicking on the respective link.