

PCAOB Reproposes Auditing Standard Regarding Communications With Audit Committees

In late December 2011, the Public Company Accounting Oversight Board (the “PCAOB”) repropose a new auditing standard, *Communications with Audit Committees* (the “Proposed Standard”), and related amendments.¹ The Proposed Standard and related amendments would replace interim standards AU sec. 380, *Communication With Audit Committees* (“AU sec. 380”), and AU sec. 310, *Appointment of the Independent Auditor* (“AU sec. 310”). The PCAOB believes the Proposed Standard would benefit investors by establishing requirements that would enhance the relevance and quality of communications between auditors and audit committees.² The communication requirements in the Proposed Standard are consistent with the requirements of the Sarbanes-Oxley Act of 2002 and are intended to enhance the communication requirements contained in the PCAOB’s existing standards. The Proposed Standard does not otherwise impose new performance requirements other than communications.

I. Background

The Proposed Standard was initially proposed in March 29, 2010 (the “Initial Proposed Standard”). After the comment period concluded, the PCAOB decided that further outreach to stakeholders would be beneficial. On September 21, 2010, the PCAOB held a roundtable to obtain additional insight on key issues including: (i) communications beneficial to audit committees, (ii) accounting policies, practices and estimates, (iii) effective two-way communication between auditors and audit committees, (iv) balancing oral and written communications, (v) audit committee responsibilities in the engagement letter, (vi) management communications and (vii) uncorrected misstatements. The PCAOB then decided to reopen the public comment period on the Initial Proposed Standard in order to give interested parties the opportunity to provide additional comments.

In response to comments received in comment letters and at the roundtable, the PCAOB revised the Initial Proposed Standard. The PCAOB is now reproposeing this auditing standard in order to:

- afford commenters the opportunity to consider the Proposed Standard in relation to eight “risk assessment standards” that serve as a foundation for future standard-setting and which the PCAOB adopted subsequent to issuance of the Initial Proposed Standard;³
- provide brokers and dealers, their auditors and board members of brokers and dealers with the opportunity to comment on the Proposed Standard in light of the fact that subsequent to the issuance of the Initial Proposed Standard, the PCAOB was granted oversight of the audits of brokers and

¹ Available at http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2011-008.pdf

² As used in the Proposed Standard and this memorandum, the term “audit committee” refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the term refers to the entire board of directors of the company.

As used in the Proposed Standard and this memorandum, the term “audit” refers either to an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

³ See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor’s Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (August 5, 2010), available at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

dealers registered with the U.S. Securities and Exchange Commission (“SEC”), pursuant to Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”);⁴ and

- include an additional requirement for the auditor to communicate to the audit committee (i) any significant unusual transactions that are outside the normal course of business for the company or that otherwise appear unusual and (ii) the auditor’s understanding of the business rationale for such transactions.

II. The Proposed Standard

Audit committees play an important role in protecting investors’ interests insofar as these committees assist the board of directors in overseeing the integrity of a company’s financial statements and the financial reporting process. The better informed an audit committee is about accounting and disclosure matters relating to the audit, the better able it is to fulfill its responsibility to shareholders. One way in which audit committees may be informed about accounting and disclosure matters is by receiving communications from auditors regarding the auditors’ evaluations of matters that are significant to the financial statements.

The Proposed Standard would require auditors to communicate to audit committees certain matters related to the conduct of an audit and to obtain certain information from audit committees that is relevant to the audit. The communication requirements included in the Proposed Standard would supplement, but not modify or replace, other PCAOB rules and standards, and other laws and regulations that require communication of specific matters between auditors and audit committees.⁵ Through adoption of the Proposed Standard, the PCAOB seeks to improve and enhance current auditor communication requirements by:

- Requiring auditors to establish an understanding of the terms of the audit engagement with the audit committee, record the terms of the engagement in an engagement letter, have the engagement letter executed by an appropriate party on behalf of the company and determine that the audit committee has acknowledged and agreed to the terms;
- Enhancing the auditor’s inquiries of the audit committee regarding matters relevant to the audit, including, but not limited to, knowledge of violations or possible violations of laws or regulations and complaints or concerns raised regarding financial reporting matters;
- Requiring auditors to communicate to audit committees an overview of the overall audit strategy, including significant risks identified by the auditor, and provide updates to audit committees about significant changes to the planned audit strategy or identified risks;
- Requiring auditors to communicate to audit committees information about any other independent public accounting firms or persons not employed by the auditor who may be involved in the audit:

⁴ See Section 982 of the Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010), available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>.

⁵ See, e.g., Auditing Standard (“AS”) No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, paragraphs 60, 62 and 64; AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraphs 78-81, 91, C7 and C14; PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.

- Requiring auditors to communicate the basis for a determination that the auditor can serve as principal auditor, in cases where significant parts of the audit will be performed by other auditors;
- Enhancing auditor communication with audit committees regarding the company's accounting policies, practices and estimates by aligning the communication requirements with auditor performance requirements;
- Requiring auditors to communicate to audit committees any difficult or contentious matters for which the auditor consulted outside the engagement team;
- Enhancing communication with the audit committee regarding the auditor's evaluation of the quality of the company's financial reporting by aligning the communication requirements with the risk assessment standards and incorporating certain SEC communication requirements;
- Requiring auditors to communicate significant unusual transactions and their understanding of the business rationale for such transactions;
- Enhancing the requirement that auditors communicate to audit committees their views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters;
- Requiring auditors to communicate to audit committees their evaluation of going concern, if applicable;
- Requiring auditors to communicate to audit committees those situations in which the auditor concludes that a departure from the standard auditor's report is necessary;
- Requiring auditors to communicate to audit committees any complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit;
- Requiring auditors to communicate to audit committees other matters arising from the audit that are significant to the oversight of the company's financial reporting process; and
- Requiring that the communications with audit committees occur before issuance of an audit report.

Although the Proposed Standard establishes certain requirements regarding auditor communications to audit committees, it does not preclude auditors from providing, or audit committees from requesting, additional information to and from each other.

III. Transitional Amendment to AU Sec. 380

As part of the same PCAOB release which sets forth the Proposed Standard, the PCAOB also proposed a transitional amendment to revise interim accounting standard AU sec. 380, *Communication With Audit Committees*. The PCAOB views this amendment as necessary to make existing audit communications rules and regulations consistent with respect to audits of brokers and dealers until the Proposed Standard becomes effective.

As mentioned above, Section 982 of the Dodd-Frank Act charged the PCAOB with oversight of the audits of brokers and dealers registered with the SEC. In response, on June 15, 2011, the SEC proposed to amend Rule 17a-5 of the Securities Exchange Act of 1934 (“Exchange Act”) to require, among other things, that audits of brokers’ and dealers’ financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.⁶ If the SEC adopts its proposed amendments to Rule 17a-5, or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the PCAOB auditing, attestation, quality control and, where applicable, independence standards would then apply to audits of brokers and dealers required by Section 17 of the Exchange Act and Rule 17a-5.

The current PCAOB interim standard, AU sec. 380, was last amended in 1999 and does not apply to audits of brokers and dealers if the broker or dealer does not have an audit committee (or equivalent body) or is registered only because of Section 15(a) of the Exchange Act. Under current requirements contained in Statement on Auditing Standards No. 114, *The Auditor’s Communication With Those Charged With Governance*, issued by the American Institute of CPAs (“AICPA”) in 2006, however, auditor communication requirements are applicable to audits of brokers and dealers. The PCAOB is concerned that this difference in applicability of the standards to the audits of brokers and dealers could result in a gap in audit committee communications if the SEC amendments to Rule 17a-5 are adopted and become effective prior to the effectiveness of the Proposed Standard. To eliminate this gap, the PCAOB is proposing to amend AU sec. 380 to delete the current exception for audits of brokers and dealers that do not have an audit committee or are registered with the SEC only because of Section 15(a) of the Exchange Act. The proposed transitional amendment would make the communication requirements in AU sec. 380 applicable to audits of issuers and brokers and dealers.

If adopted, the Proposed Standard would supersede AU sec. 380 and its communication requirements would apply to audits of brokers and dealers. Thus, the amendment to AU sec. 380 would just be a temporary, stop-gap measure to make existing audit communication rules and regulations consistent with respect to audits of brokers and dealers until the Proposed Standard takes effect.

IV. Comment Period and Effective Dates

Comments on the Proposed Standard and related amendments and on the proposed transitional amendment to AU sec. 380 are due on or before February 29, 2012. If adopted, the PCAOB anticipates that the Proposed Standard and related amendments would be effective, subject to SEC approval, for audits with fiscal years beginning on or after December 15, 2012. The transitional amendment to AU sec. 380 is anticipated to be effective, subject to SEC approval, for the periods that PCAOB standards become applicable to audits of brokers and dealers as designated by the SEC upon adoption of its amendments to Rule 17a-5.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

⁶ See Exchange Act Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011), available at <http://www.sec.gov/rules/proposed/2011/34-64676.pdf>.