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Legal Update
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Public Accounting Oversight Board Pronouncements Regarding Communications with Audit Committees and PCAOB Inspection Information

On August 15, 2012, the Public Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 16, *Communications with Audit Committees*.[1] While the new standard still needs to be approved by the Securities and Exchange Commission, the PCAOB anticipates that this standard will be effective for audits of fiscal years beginning on or after December 15, 2012.

Once approved by the SEC, Auditing Standard No. 16 will supersede AU sec. 380, *Communication With Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor*. The PCAOB also issued a release on August 1, 2012, entitled *Information for Audit Committees About the PCAOB Inspection Process*.[2] These two recent PCAOB releases contain information that is important for the audit committees of public companies and the people who work with such committees.

Auditing Standard No. 16

Auditing Standard No. 16 impacts communications standards that are relevant to the audit; it does not otherwise impose any new performance requirements for the audit. The new standard retains, and in some cases enhances, many of the communications requirements of AU sec. 380, as well as incorporating SEC communications requirements from Section 10A(k) of the Securities Exchange Act of 1934. Auditing Standard No. 16 also adds new auditor communication requirements.

While Auditing Standard No. 16 provides standards for communications with audit committees, these standards do not preclude auditors from providing additional information to audit committees, or from responding to audit committee requests for additional information. Auditing Standard No. 16 is designed to encourage constructive, two-way communication between the auditor and the audit committee throughout the audit process that is tailored to circumstances, as opposed to boiler-plate communication.

An important feature of Auditing Standard No. 16 is that it requires the audit firm to communicate audit strategy and results to the audit committee prior to the issuance of the auditor's report. This feature is intended to provide time for the audit committee and the auditor to take appropriate action to address the matters communicated.

The PCAOB believes that timely communications between the audit committee and the auditor help to improve the audit. These communications may provide the audit committee, which has responsibility for the oversight of financial reporting, with information about significant matters related to the audit and the financial statements. Through these communications, the auditor may obtain

the audit committee's insights as well as information about transactions and events. These communications also may enable the auditor to learn about complaints regarding accounting or auditing matters. In addition, they may assist the auditor in gaining a better understanding of the company and its control environment.

Auditing Standard No. 16 enhances auditor communication requirements relating to the following:

- Certain matters regarding the company's accounting policies, practices and estimates;
- The auditor's evaluation of the quality of the company's financial reporting;
- Information related to significant unusual transactions, including the business rationale for such transactions; and
- The auditor's 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.

The new standard expands the required inquiry of the audit committee regarding matters important to identifying and assessing the risks of material misstatements and fraud, including whether the audit committee is aware of relevant matters such as possible violations of laws or regulations. New auditor communication requirements as a result of Auditing Standard No. 16 include:

- An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified and significant changes to the planned audit strategy or identified risks;
- Information about the nature and extent of specialized skill or knowledge needed in the audit, the extent of the planned use of internal auditors, company personnel or other third parties, and other independent public accounting firms or other persons not employed by the auditor that are involved in the audit;
- The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
- Situations in which the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting;
- Difficult or contentious matters for which the auditor consulted someone outside the engagement team;
- The auditor's evaluation of going concern;
- Departure from the auditor's standard report; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit.

The Jumpstart Our Business Startups Act, enacted in April of 2012, requires the SEC to separately determine whether new auditing standards, such as Auditing Standard No. 16, are applicable to emerging growth companies. The PCAOB is requesting that the SEC approve the application of Auditing Standard No. 16 to audits of emerging growth companies.

Information about the PCAOB Inspection Process

The PCAOB issued its release on the inspection process to assist audit committees in understanding the PCAOB's inspections of audit firms and to suggest ways for audit committees to gather useful information from their audit firms about such inspections.

Pursuant to the Sarbanes-Oxley Act of 2002, the PCAOB is required to conduct regular inspections of accounting firms that provide audit reports for public companies with SEC reporting obligations. PCAOB inspection findings are contained in two of the four parts of an inspection report. Part I findings, which are public and available on the PCAOB's web site, describe audit deficiencies relating to an auditor's failure to gather sufficient audit evidence to support an audit opinion. Part II findings typically describe deficiencies in an audit firm's overall system of quality control.

The PCAOB is not permitted to publicly release Part II findings unless the audit firm fails to remedy those findings within 12 months of the issuance of the inspection report. However, the audit firm is given copies of this part of the PCAOB report and is not prohibited from releasing this information, for example, to the audit committee of its audit client. The PCAOB inspection process is described more fully in an appendix to the release.

While acknowledging that each audit committee must judge for itself the extent to which it wishes to explore PCAOB inspection issues with its auditors, the PCAOB suggested that audit committees may wish to ask their audit firms the following questions:

- Was the company's audit selected for PCAOB inspection?
- Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit?
- What were the audit firm's responses to the PCAOB findings?
- What topics are included in Part II findings?

The PCAOB observed that audit committees might wish to ask the audit firm to keep them informed if the company's audit is selected for review in an inspection and, if selected, to keep them informed of concerns arising during the course of the inspection, in addition to when the final inspection report is issued.

The PCAOB suggested that audit committees might benefit from having the audit firm provide timely information about the following aspects of inspection results:

- Whether anything has come to the firm's attention suggesting the possibility that an audit opinion on the company's financial statements is not sufficiently supported, or otherwise reflecting negatively on the firm's performance on the audit, and what, if anything, the firm has done or plans to do about it;
- Whether a question has been raised about the fairness of the financial statements or the adequacy of the disclosures;
- Whether a question has been raised about the auditor's independence relative to the company;
- Whether any of the matters described in the public portion of an inspection report on the firm, whether or not they involve the company's audit, involve issues and audit approaches similar to those that arise or could arise in the audit of the company's financial statements;
- To the extent any such similarity exists, whether and how the firm has become comfortable that the same or similar deficiencies either did not occur in the audit of the company's financial statements or have been remedied; and
- How issues described by the PCAOB in general reports summarizing inspection results across groups of firms relate to the firm's practices, and potentially the audit of the company's financial statements, and how the firm is addressing those issues.

The PCAOB noted that audit committees might want to learn what changes had been made to the policies and procedures of the audit firms, either to address quality control issues indicated by deficiencies or to reduce the chances that

deficiencies noted in other audits would arise in audits of their companies' financial statements.

The release suggested that an audit committee might also want to be apprised of the status of the audit firms' quality control remediation process, including whether the audit firm responded to the PCAOB inspection report quality criticisms within the 12-month deadline provided by the inspection procedure, and whether the PCAOB has made a final determination, including a negative determination that has not yet become public.

The PCAOB urged audit committees to view with skepticism the following answers to questions about an audit firm's responses to PCAOB findings:

- "It was just a documentation problem."
- "There was a difference in professional judgment."
- "The firm has addressed the criticisms in accordance with PCAOB standards."

To the extent that audit firms provide explanations of criticisms in broad terms, audit committees may want to request additional details or seek further clarification. If an audit firm is reluctant to share details of Part II findings, the PCAOB suggested that audit committees may want to ask for generic information about the findings, such as:

- The changes the audit firm is making to address quality control deficiencies;
- The progress of the quality control remediation process;
- The inspected years about which the PCAOB has made a final determination about the firm's remediation efforts and the nature of the determination; and
- Whether the PCAOB has provided initial indications that the audit firm may not have sufficiently remediated items.

Practical Considerations

Public companies should inform their audit committees of the PCAOB developments regarding communications between auditors and audit committees.

Auditing Standard No. 16 must be approved by the SEC before it can become effective. The PCAOB has proposed that it be made effective for audits of fiscal years *beginning* on or after December 15, 2012. Therefore, the new standard will not impact audits of current fiscal years, although it is possible that some audit firms might increase their communications with audit committees before then.

If they choose to do so, audit committees may immediately use any of the approaches for gathering information about PCAOB inspections from their audit firms that are described in *Information for Audit Committees about the PCAOB Inspection Process*.

If you have any questions regarding the PCAOB audit committee releases, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group..

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Endnotes

[1] See PCAOB Release 2012-004 dated August 15, 2012, which can be found in PCAOB Docket 030: Auditing Standard on Communications with Audit Committees and Related Amendments to PCAOB Standards at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx.

[2] See PCAOB Release No. 2012-003 dated August 1, 2012 , which can be found at http://pcaobus.org/News/Releases/Pages/08012012_InspectionProcess.aspx.

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