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Alert
SEC Disclosure and Corporate Governance

The PCAOB Promotes Auditor – Audit Committee Communication with a New Standard and New Guidance

The Public Company Accounting Oversight Board recently took two significant actions to eliminate perceived constraints on communications, and foster constructive two-way discussions, between auditors and audit committees. On August 15, 2012, the PCAOB adopted Auditing Standard No. 16, *Communications with Audit Committees* ("AS 16"), and related amendments to other PCAOB standards to expand the auditor's required communications and otherwise enhance the "relevance, timeliness, and quality" of communications between auditors and audit committees.[1] This followed by two weeks the PCAOB's issuance of Release No. 2012-0003, *Information for Audit Committees about the PCAOB Inspection Process* (the "Inspection Release"), to encourage audit committees to ask, and auditors to answer, questions about the outcome of PCAOB inspections.[2]

This Alert examines these developments from the audit committee's perspective. As the PCAOB has acknowledged, it has no statutory authority over public companies or their audit committees. Accordingly, each audit committee will be free to determine for itself (1) how it will use the information that (upon effectiveness) AS 16 will require its auditor to communicate and (2) whether, relying on the new guidance, it will solicit from its auditor information about the firm's PCAOB inspections (which the PCAOB is prohibited from requiring the auditor to communicate).

AS 16 does not require the auditor to evaluate the effectiveness of two-way communication between the auditor and audit committee, as originally had been proposed. The PCAOB has noted, however, that the absence of such a requirement does not change the auditor's responsibility under other PCAOB standards to assess the audit committee's effectiveness.[3] It remains to be seen whether, if expectations about the audit committee's level of dialogue with the auditor evolve as the PCAOB urges, this will ultimately play a part in the assessment.

Effectiveness

The guidance contained in the Inspection Release may be applied at any time. As with all PCAOB standards, however, AS 16 must be approved by the Securities and Exchange Commission. If approved as contemplated, AS 16 will be effective for audits of fiscal years beginning on or after December 15, 2012 and related amendments to AU sec. 722, Interim Financial Information, will be effective for reviews of fiscal quarters also beginning on or after that date. Thus, in the case of calendar year companies, audit committees should be aware that the new standard will apply to the auditor's review of the financial statements for the first quarter of 2013 and will also apply to engagement of the auditor for the 2013 audit (which usually takes place in the first quarter).

As pointed out at the PCAOB's August 15, 2012 open meeting, nothing precludes either an audit firm from "early adopting" AS 16 or an audit committee from requesting that an auditor discuss matters covered by AS 16 before it becomes effective.[4] Accordingly, audit committees should also consider that AS 16 may be implemented on a voluntary basis, in whole or in part, in communications regarding audits and reviews of earlier reporting periods, particularly a calendar year company's 2012 audit.

AS 16 Communication Requirements

AS 16 reflects the PCAOB's conviction that a meaningful exchange of information helps both auditor and audit committee discharge their respective responsibilities under the Sarbanes-Oxley Act of 2002 ("SOX") and related stock exchange listing standards and SEC rules to protect the interests of investors: it enhances the audit committee's ability to oversee the audit and the company's financial reporting processes generally and, at the same time, it enhances the effectiveness of the audit by providing the auditor with a forum separate from management in which to discuss audit and financial reporting issues. The new standard supersedes interim standards AU sec. 310, *Appointment of the Independent Auditor*, and AU sec. 380, *Communication With Audit Committees*, which were adopted prior to the passage of SOX. It harmonizes more closely with SOX in two key respects:

- Under AU sec. 310, auditors have been required to establish an understanding of the terms of their engagement with the "client," which can be interpreted as company management. AS 16 clarifies that the auditor must establish this understanding with the audit committee. This aligns with the SOX requirement that audit committees of listed companies be responsible for the appointment, compensation and oversight of the independent auditor.[5]
- Under AU sec. 380, audit committee communications have been considered incidental to the audit and have not been required to be made prior to the issuance of the audit report. Again in alignment with SOX, AS 16 reflects the view that these communications are integral to the audit and, accordingly, requires auditors to communicate the audit strategy and audit results in a timely manner and prior to issuance of the audit report.

AS 16 retains many communication requirements of AU sec. 380 and incorporates existing SEC communication requirements.[6] However, as detailed below, it also expands the scope of required communications in many areas. Moreover, in keeping with the overall theme of open communications, AS 16 makes clear that it does not preclude an auditor from providing, either on its own initiative or in response to an audit committee request, information above and beyond the newly enhanced minimum requirements.[7]

The new standard is intended to be flexible. First, as long as a communication is made prior to issuance of the audit report, AS 16 leaves the precise timing to the auditor's discretion based on factors such as the significance of the matter and the need for corrective or follow up action. Moreover, in the interests of timeliness, an auditor may communicate only with the audit committee chair as long as it makes the communication to the committee prior to issuing its report. Second, the required communications may be scaled depending on the size and complexity of the particular company under audit. Communications are required only to the extent that they are relevant to a particular audit. Third, the required communications may be oral or written (but, in either case, documented in the work papers). Finally, as discussed under "*Results of the Audit*," where management takes the lead on certain communications, the auditor need not repeat them at the same level of detail as long as certain requirements are met.

Required Communications Relating to the Audit

The requirements of AS 16 are divided into the four stages described below.

Appointment and Retention of the Auditor. At the outset, similar to AU sec. 310, AS 16 requires the auditor to establish an understanding of the terms of the audit engagement, including the objective of the audit and the respective responsibilities of the auditor and management. As noted above, however, AS 16 specifically requires that the understanding be with the audit committee.[8] In addition, AS 16 requires the auditor to record the understanding in an engagement letter that addresses certain specified matters and to provide the engagement letter to the audit committee annually.[9] AS 16 does not prescribe who must sign the letter. However, if the letter is executed on behalf of the company by a party other than the auditor or its chair (acting on behalf of the committee), the audit committee must determine that the audit committee has acknowledged and agreed to the terms of the engagement. This may be demonstrated by the audit committee or chair signing either the engagement letter or a separate form, through the minutes of an audit committee meeting or by an oral statement (in which case the auditor must document it in the work papers).[10]

AS 16 retains the requirement of AU sec. 380 that the auditor discuss with the audit committee any significant issues that it discussed with management in connection with its appointment or retention. This includes significant discussions regarding the application of accounting principles and auditing standards.[11] The communication is intended to put the audit committee on notice of certain factors that could influence management's views if, as is generally the case, the committee solicits management's views about appointing or retaining the auditor.

Audit Strategy. AS 16 requires the auditor to give the audit committee an overview of the overall audit strategy, including the timing of the audit and the "significant" risks – defined as risks of material misstatement that require special audit consideration – that the auditor has identified during its risk assessment procedures.[12] In this connection, the auditor must communicate the nature and extent of any specialized skill or knowledge needed in the audit, and the extent to which the auditor plans to use work performed by the company's internal auditor or other personnel, other independent public accounting firms or other third parties.[13] If significant parts of the audit will be performed by other auditors, the auditor must give the basis for its determination that it can serve as principal auditor.[14] Finally, as the audit progresses, the auditor must communicate any significant changes that are made to the planned audit strategy or that are identified as significant risks and the reasons for the changes.[15]

Obtaining Information from the Audit Committee Relevant to the Audit. Currently, the auditor is required to ask the audit committee or its chair about risks of material misstatement, including fraud risks, such as whether the committee is aware of tips or complaints regarding the company's financial reporting.[16] To further stimulate a two-way dialogue, AS 16 expands the auditor's required inquiries to include whether the audit committee is aware of matters relevant to the audit, including but not limited to violations or possible violations of laws or regulations.[17] The PCAOB notes that the reference to violations is meant only as an example of matters that should be discussed; such matters are expected to vary from audit to audit. The PCAOB also indicated that the requirement is intended to enable the auditor to obtain the committee's perspective, which may differ from that of management.

Results of the Audit. Consistent with their fundamental importance to the financial statements – as recognized by SOX and underscored by the financial crisis – AS 16 contains extensive communication requirements relating to "significant" and "critical" accounting policies and practices, "critical" accounting estimates and "significant unusual" transactions. The standard focuses the auditor's communications on areas that involve high degrees of uncertainty, subjectivity and judgment and therefore create higher risks of material misstatement (offering as examples certain fair value estimates). It also mandates the auditor's qualitative evaluation of these matters, including indications of possible bias on the part of management, the basis for conclusions about the reasonableness of critical estimates and the business rationale for significant unusual transactions. Certain of the key definitions have been conformed to the SEC's usage in rules or interpretive guidance so that the communications will revolve around the same concept, whether they relate to the financial statements, MD&A or other disclosures. In addition, the new standard requires the auditor to make communications regarding uncorrected misstatements (including the basis for the determination that they were immaterial) and non-trivial corrected misstatements that might not have been detected without the audit (including the implications of this for internal control over financial reporting).

AS 16 recognizes that management may have direct discussions with the audit committee concerning accounting policies and practices, estimates, significant unusual transactions and corrected and uncorrected misstatements. In order to streamline discussion, AS 16 does not require the auditor to communicate these matters at the same level of detail as management has provided if the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the committee that management adequately communicated these matters and (3) identified for the committee those accounting policies and practices the audit committee considers "critical." AS 16 requires the auditor to fill in any gaps or, where necessary, correct what management has said.

AS 16 also requires the auditor to make the audit committee aware of areas of significant deliberation, debate or even tension between the auditor and management. These include "difficult or contentious matters" for which the engagement team consulted the national office, matters of concern to the auditor where it is aware that management consulted other auditors, disagreements with management (whether or not satisfactorily resolved) over significant matters and significant delays and difficulties the auditor encountered in performing the audit. Where substantial doubt exists, at least initially, AS 16 requires significant communications about the company's ability to continue as a going concern. (Audit committees should also be aware that "going concern" is currently the focus of major projects by both the PCAOB and FASB.)

For a comprehensive list of required communications relating to audit results, see Annex A.

Required Communications Relating to Interim Reviews

As noted above, AS 16 amends various PCAOB standards, including AU Sec. 722, Interim Financial Information. As amended, this standard directs an auditor conducting a review of interim financial information to determine whether any of the matters described in AS 16, as they relate to interim information, have been identified. If this is the case, the auditor must communicate them to the audit committee, or at least the chair, in a timely manner and prior to the company filing its quarterly report on Form 10-Q with the SEC. In particular, the amended standard requires communication of the following: (1) a description of the process management used to develop the critical accounting estimates; (2) a change in a significant accounting policy affecting the interim financial information; (3) misstatements that, either individually or in the aggregate, could have a significant effect on the company's financial reporting process; and (4) uncorrected misstatements aggregated by the auditor that management determined to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole.

The amended standard recognizes that management might communicate to the audit committee some or all of the matters relating to accounting policies, practices, estimates and significant unusual transactions referred to in AS 16. If it does, the auditor need not communicate them at the same level of detail as management, provided that – similar to the conditions described above with respect to the audit – the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the committee that management has adequately communicated these matters and (3) with respect to critical accounting policies and practices, identified for the audit committee those it considers "critical". Again, the auditor must communicate any omitted or inadequately described matters.

Special Applications

Application of AS 16 to Audits of Emerging Growth Companies (EGCs). As the first auditing standard adopted by the PCAOB subsequent to enactment of the JOBS Act, AS 16 is subject to a separate determination by the SEC regarding its applicability to audits of EGCs.[18] The PCAOB indicated that it will request that the SEC approve the application of AS 16, and the related amendments, to audits of EGCs.

Application of AS 16 to Audits of Brokers and Dealers. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 charged the PCAOB with oversight of the audits of brokers and dealers registered with the SEC. To implement this, the SEC has proposed amendments to Rule 17a-5 under the Securities Exchange Act of 1934.[19] If the proposed amendments are adopted (or the SEC provides similar direction) after AS 16 becomes effective, AS 16 will apply to audits of brokers and dealers. To address the possibility that the proposed amendments are adopted (or the SEC provides similar direction) before AS 16 becomes effective, the PCAOB has adopted a transitional amendment to AU sec. 380, the interim communication standard discussed above, to ensure that it will apply to audits of all brokers and dealers (including some currently exempted) until AS 16 becomes effective.[20]

What To Do Now:

- Audit committees should take the opportunity AS 16 presents to open a dialogue with their auditor about the nature and timing of communications that the committee believes would be most useful to it.
- Audit committees should also discuss whether they would like their auditors to accelerate the application of AS 16 in whole or in part, particularly in presenting the results of the 2012 annual audit for calendar year companies.
- Audit committees should expect greater formality in the engagement letter process. As discussed in Part II of this alert, the engagement process offers audit committees an opportunity to discuss with the auditor the committee's expectations regarding disclosures by the firm about PCAOB inspections.
- Audit committees should consider and discuss with management whether modifications should be made to timing and other aspects of the company's disclosure controls and procedures and internal control over financial reporting in order to benefit from the expanded panoply of communications to be received from the auditor in connection with the annual audit and interim reviews.
- Audit committees should review their committee charters in light of the procedural and communication requirements of the new standard.

Discussion of PCAOB Inspection Results

SOX requires the PCAOB to conduct regular inspections of registered public accounting firms that provide audit reports for SEC registrants in order to assess the firms' compliance with applicable laws, rules and professional standards. Although the PCAOB provides inspection reports in their entirety to the SEC, SOX prohibits the PCAOB from (1) disclosing a significant portion of the inspection-generated information to the public, (2) disclosing that information to an audit committee or (3) compelling an audit firm to disclose it to an audit committee. The restricted information includes whether the PCAOB has identified deficiencies in the audit of the audit committee's own company as well as (for a minimum of 12 months) the "Part II" information discussed below.

The PCAOB issued the Inspection Release in light of its concerns that some audit firms either decline to discuss the results of their inspections when requested by the audit committee or, if they do discuss the results, downplay the results of any adverse findings. The Inspection Release provides information to enhance audit committees' general understanding of the inspection process and the meaning of reported results. It then suggests how audit committees can initiate or improve discussions with the auditors about the results of the audit firm's inspections. As the Inspection Release emphasizes, although the PCAOB's own hands are tied by SOX, the statute does not prohibit audit firms from releasing non-public inspection information at any time nor does it prohibit audit committees from requesting that information.

Background on PCAOB Inspections

As described more fully in the Inspection Release, PCAOB inspections are designed to identify weaknesses and deficiencies in how an audit firm conducts audits. They involve in-depth examinations of (1) certain aspects of a limited number of audits performed by the audit firm, and (2) certain elements of the firm's system of quality control over its audit processes. In selecting aspects of audits for review, the PCAOB generally takes a risk-based approach, focusing on factors such as (1) the nature of the company or its industry, (2) audit issues likely to be encountered, (3) the company's market capitalization, (4) whether it has significant operations in certain emerging markets, (5) considerations related to the particular firm, practice office or partner, including prior inspection results and (6) any other relevant information that has come to the PCAOB's attention.

For each inspection that its staff conducts, SOX requires the PCAOB to prepare a written report, to give the audit firm an opportunity to respond to a draft of the report and to include the firm's written response as part of the final report. The inspection staff does not confer with management of the company whose audit is being inspected. Inspection findings are presented in two distinct parts of an inspection report:

- ***Part I –*** This describes audit deficiencies at a level where the PCAOB's inspection staff found that the auditor failed to gather sufficient evidence to support an audit opinion that the financial statements are free of material misstatement. The finding does not necessarily mean, however, that the financial statements are misstated. Part I findings are made public and are available on the PCAOB's web site. However, the names of the companies whose audits have been inspected are not disclosed.
- ***Part II –*** This typically describes deficiencies in the audit firm's overall system of quality control at a level where the PCAOB doubts that the system provides reasonable assurance that professional standards are met. The PCAOB is prohibited by SOX from publicly releasing Part II

findings unless the audit firm fails to take satisfactory remedial action within 12 months of issuance of the inspection report.[21]

The Inspection Release cautions that, because a PCAOB inspection does not encompass all of a firm's audits or every aspect of selected audits, audit committees should not interpret the public portion of a report as indicating that either the firm's work as a whole, or any particular company's financial statements or reporting on internal control, is or is not free of deficiencies beyond those specifically described.

Audit committees should be aware that, after the PCAOB has issued an inspection report, it transmits the report to the SEC, *naming the companies whose audits have been criticized*. The PCAOB also provides separate detailed reports to the SEC – sometimes well before issuance of the report – if, for example, the inspection indicates to the PCAOB staff that the company's financial statements may be materially misstated, the company may have an undisclosed material weakness in internal control over financial reporting, the company's auditor may not be "independent" within the meaning of SOX and SEC implementing rules[22] or the company may otherwise have violated laws or SEC rules. The Inspection Release underscores the audit firm's ability to give the audit committee a "head's up" in these circumstances since, according to the PCAOB, inspectors generally raise issues with the audit firm before conveying them to the SEC.[23]

Possible Audit Committee Questions About Inspections

In the Inspection Release, the PCAOB offers "possible questions" that audit committees may wish to ask their audit firms and some pointed advice about how to interpret the firm's responses:

- ***Was the company's audit selected for PCAOB inspection?*** The PCAOB suggests that audit committees may wish to know in real time whether their audit has been selected, areas of review, and any deficiencies identified by the PCAOB. Specific areas for inquiry include:
  - Whether anything has come to the firm's attention suggesting 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 in response;
  - Whether a question has been raised about the fairness of the financial statements or the adequacy of the disclosures; and
  - Whether a question has been raised about the auditor's independence relative to the company.
- ***Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit?*** The PCAOB suggests that audit committees may wish to understand, if so, how the firm has become comfortable that the same or similar deficiencies either did not occur, or have been remedied, in the company's audit.
- ***What were the audit firm's responses to the PCAOB findings?*** The PCAOB suggests that audit committees may wish to know whether and why the audit firm agreed or disagreed with the PCAOB's findings. If the firm agreed, what remedial steps did it take? In this connection, the PCAOB identified certain audit firm responses that it believes should be viewed with skepticism:
  - *"It was just a documentation problem."* According to the Inspection Release, the PCAOB bases deficiency findings on an absence of available evidence in the audit files or elsewhere to establish that adequate work was done to support an audit opinion, not just a failure to document such work.

  - *"There was a difference in professional judgment."* According to the Inspection Release, the PCAOB bases deficiency findings only on failures to obtain sufficient audit evidence, not on disagreements when reasonable judgments appear to have been made.
  - *"The firm has addressed the criticisms in accordance with PCAOB standards."* According to the Inspection Release, professional standards require that certain remedial steps be taken when a required auditing procedure has been omitted. The PCAOB encourages audit committees to inquire whether the firm performed more work in response to the finding or in subsequent audits, or whether the firm concluded that no additional steps were required (which effectively means that the firm disagreed with the PCAOB's findings).
- ***What topics are included in Part II findings?*** The PCAOB suggests that even if audit firms are hesitant to disclose the details of Part II findings about them, audit committees may wish to request certain generic information about the findings, such as:
  - What changes the firm is making in its policies and procedures to address any quality control deficiencies;
  - What is the progress of the quality control remediation process, including a discussion of any submissions the audit firm made to the PCAOB as part of that process;
  - The inspected years about which the PCAOB has made a final determination about the firm's remediation efforts and the nature of that determination; and
  - Whether the PCAOB has provided initial indications that the audit firm may not have sufficiently remediated any items.
- ***Finally, how do issues described by the PCAOB in general reports summarizing inspection results across groups of firms relate to the firm's practices, and potentially its audit of the company's financial statements, and how the firm is addressing those issues?***

What To Do Now:

- Audit committees should take the PCAOB's encouragement to heart and seek to establish – or, where it already informally exists, confirm – an understanding with their auditor about the nature and timing of communications the firm will make to the committee concerning PCAOB inspection results.
- Audit committees should ask now – and seek to ensure that in the future they will be informed in real time – about (1) the selection of their company's audit for review, the progress of that review and its outcome and (2) deficiencies identified by the PCAOB in the audit firm's audits of other companies that present similar issues.
- Audit committees should also ask now – and seek to ensure that in the future they will be informed promptly, and in any event prior to engaging the firm for the next fiscal year – about any "Part II" quality control deficiencies identified by the PCAOB and the status of any remedial efforts by the firm.
- In annually engaging an auditor, audit committees may wish to take into account the firm's willingness to establish these understandings.

Annex A

Required Auditor Communications Relating to Audit Results

- ***Significant accounting policies and practices:*** Management's initial selection of significant accounting policies and the application of such policies in the current period, and whether they represent changes from policies and applications utilized by management in the past. Also, the effect on financial statements or disclosures of significant policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance, or a diversity in practice.[24]
- ***Critical accounting policies and practices:*** All "critical accounting policies and practices" to be used in the current year, including the reasons for considering them to be "critical" and whether current and anticipated future events may affect the determination of "critical."[25]
- ***Critical accounting estimates:*** A description of the process management used to develop "critical accounting estimates," significant assumptions used by management in these estimates that have a high degree of subjectivity, and any significant changes management made to the processes used to develop these estimates and assumptions (including the reasons for the changes and the effects of the changes on the financial statements).[26]
- ***Significant unusual transactions:*** Significant transactions outside the normal course of business (or that otherwise appear unusual due to their timing, size or nature) and the policies and practices management used to account for them.[27] The PCAOB notes that such transactions, at times, have been considered a contributing factor in attempts to mislead investors about a company's financial condition and, therefore, informing the audit committee about them could aid its oversight of the financial reporting process.
- ***The auditor's evaluation of the quality of the company's financial reporting in the above areas and certain additional areas:***
  - Qualitative aspects of significant accounting policies and practices, including situations where the auditor has identified bias in management's judgments about the amounts and disclosures in the financial statements. Also, the results of the auditor's evaluation of differences between estimates best supported by the audit evidence and estimates included in the financial statements that, while individually reasonable, indicate possible management bias.[28] The PCAOB notes that this is similar to a superceded requirement of AU sec. 380 that the auditor discuss its judgments as to the quality, not just the acceptability, of the company's accounting principles.
  - Management's disclosures related to critical accounting policies and practices, along with any significant disclosure modifications proposed by the auditor that management did not make.[29]
  - The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.[30]
  - The auditor's understanding of the business rationale for significant unusual transactions.[31]
  - The conformity of the financial statement presentation (including the footnotes) with the applicable financial reporting framework.[32]
  - Any identified concern about management's anticipated application of new accounting pronouncements that are not yet effective.[33]

    - All permissible alternative accounting treatments related to material items that have been discussed with management, the ramifications of their use and the auditor's preferred treatment.[34]
- ***Other information:*** Identified inconsistencies or misstatements of fact in the non-financial statement portions of documents containing audited financial statements.[35]
- ***Difficult or contentious matters:*** Difficult or contentious matters for which the auditor consulted outside the engagement team and that the audit committee reasonably determined are relevant to the audit committee's oversight responsibilities.[36] The PCAOB notes that these are generally the critical matters that concern the auditor when making its final assessment of whether the financial statements are presented fairly, and often involve significant points of disagreement, debate or deliberation between the auditor and management. The PCAOB also notes that nothing precludes the auditor from going beyond the requirement and communicating difficult or contentious matters that did not involve outside consultation.
- ***Management's consultation with other accountants:*** The auditor's views about significant auditing or accounting matters where the auditor is aware management consulted other auditors and the auditor has identified a concern.[37]
- ***Going concern issues:*** Where applicable, the auditor's evaluation of the company's ability to continue as a going concern.[38] First, the conditions and events that, when considered in the aggregate, indicated to the auditor that there is substantial doubt about the company's ability to continue as a going concern for a reasonable period to time. Second, the auditor's conclusion after considering management's plans: either that the substantial doubt is alleviated and the specific reasons why; or, if not alleviated, the effects of the circumstances on the financial statements, the adequacy of any related disclosure, and the effects on the audit report.
- ***Uncorrected and corrected misstatements:*** The schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management and (unless the auditor determines that management has adequately discussed this with the audit committee) the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors considered. Also, all non-trivial corrected misstatements that might not have been detected absent the audit and the implications of this for the company's financial reporting process.[39]
- ***Material written communications:*** Other material written communications between the auditor and management beyond those required by AS 16 or other PCAOB standards.[40]
- ***Departure from the auditor's standard report:*** The reasons for and wording of any proposed modification of the opinion or any explanatory language.[41]
- ***Disagreements with management:*** Any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report.[42] The PCAOB notes that this requirement is intended to capture the "areas of tension" between the auditor and management, rather than "differences of opinion" based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional facts or information prior to issuance of the audit report.
- ***Difficulties encountered in performing the audit:*** Any significant difficulties encountered during the audit, including but not limited to significant delays by management, unavailability of personnel, unwillingness of management to provide information, unreasonable time pressure,

unexpected extensive effort required to obtain audit evidence, unreasonable restrictions imposed by management, or management's unwillingness to address going concern issues at the auditor's request.[43]

- ***Other matters:*** 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 and the results of the auditor's procedures regarding these matters.[44] (With respect to the results of PCAOB inspections, the PCAOB indicated that it can only encourage, not compel, an audit firm to communicate about these matters – for its encouragement, *see* Section II of this Alert.)

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any of the following:

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We thank our colleague Audrey Susanin for her contribution to this Alert.

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Endnotes

[1] AS 16 is available on the PCAOB website at: http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf. The new standard was initially proposed in March 2010 and reproposed in December 2011. *See* Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards, PCAOB Release No. 2010-001 (March 29, 2010) and Proposed Auditing Standard Related to Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU sec. 380, PCAOB Release No. 2011-008 (Dec. 20, 2011).

[2] The release, issued on August 1, 2012, is available on the PCAOB web site at: http://pcaobus.org/News/Releases/Pages/08012012_InspectionProcess.aspx.

[3] *See* Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, paragraph 79, and Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatements* ("AS 12"), paragraphs 23-24.

[4] *See* Published Statement of Jay D. Hanson (August 15, 2012) available on the PCAOB website at: http://pcaobus.org/News/Speech/Pages/08152012_HansonStatement.aspx.

[5] *See* Section 301 of SOX and Section 10A(m)(2) of the Securities Exchange Act of 1934 (the "Exchange Act")..

[6] *See* Section 10A(k) of the Exchange Act and SEC Rule 2-07(a)(1)-(3).

[7] *See* AS 16, paragraph 2.

[8] *See* AS 16, paragraph 3.

[9] *See* Appendix C to AS 16.

[10] *See* AS 16, paragraph 6.

[11] *See* AS 16, paragraph 4.

[12] *See* AS 16, paragraph 9. The PCAOB cautioned that this does not require the auditor to divulge specific details that would compromise the effectiveness of the audit. *See also* Auditing Standard No. 9, *Audit Planning*, and AS No. 12.

[13] *See* AS 16, paragraph 10.

[14] *See* AS 16, paragraph 10(e).

[15] *See* AS 16, paragraph 11.

[16] *See* AS No. 12.

[17] *See* AS 16, paragraph 8.

[18] Pursuant to Section 104 of the Jumpstart Our Business Startups Act of 2012, any rules adopted by the PCAOB subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."

[19] *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.

[20] Currently AU sec. 380 does not apply to 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.

[21] *See* SOX Section 105(b)(5)(A).

[22] *See* Rule 2 01 of Regulation S X

[23] In a recent challenge to the confidentiality of Part II information based on the fact that the auditor had discussed it with the audit committee, the Center for Audit Quality has urged the court to deny a motion to compel production on the ground that such discussions do not constitute a waiver of the privilege.

[24] *See* AS 16, paragraph 12(a).

[25] *See* AS 16, paragraph 12(b). "Critical accounting policies and practices" are defined as those policies and practices that are both the most important to portraying the company's financial condition and results and require management's most difficult, subjective or complex judgments, often due to the need to make estimates about inherently uncertain matters.

[26] *See* AS 16, paragraph 12(c). A "critical accounting estimate" is defined as an accounting estimate where (i) the nature of the estimate is material due to the levels of subjectivity and judgment involved and (ii) the impact of the estimate on financial condition or operating performance is material.

[27] *See* AS 16, paragraph 12(d).

[28] *See* AS 16, paragraph 13(a).

[29] *See* AS 16, paragraph 13(b). The requirement is based on Section 10A(k) of the Exchange Act.

[30] *See* AS 16, paragraph 13(c).

[31] *See* AS 16 paragraph 13(d).

[32] *See* AS 16, paragraph 13(e).

[33] *See* AS 16, paragraph 13(f).

[34] *See* AS 16, paragraph 13(g). This requirement is consistent with Section 10A(k) of the Exchange Act and SEC Rule 2-07.

[35] *See* AS 16, paragraph 14.

[36] *See* AS 16, paragraph 15. The term "difficult" or "contentious matter" is used in Auditing Standard No. 7, Engagement Quality Review.

[37] *See* AS 16, paragraph 16.

[38] *See* AS 16, paragraph 17.

[39] *See* AS 16, paragraphs 18-19.

[40] *See* AS 16, paragraph 20.

[41] *See* AS 16, paragraph 21.

[42] *See* AS 16, paragraph 22.

[43] *See* AS 16, paragraph 23.

[44] *See* AS 16, paragraph 24.