

## Heads Up

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## A Summary of the May 17 Meeting of the PCAOB's Standing Advisory Group

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At the May 17, 2012, PCAOB Standing Advisory Group (SAG) meeting, the PCAOB gave an update on recent developments, including an overview of current and future standard-setting activities. In addition, the PCAOB and SAG discussed the following: possible future topics for SAG discussions; the auditor's consideration of going-concern matters; and the PCAOB's recent proposed auditing standard on related parties, significant transactions, and executive compensation.

The next SAG meeting is scheduled for November 15–16, 2012.

### Recent PCAOB Developments

Chairman James Doty gave an update on several PCAOB activities and policy initiatives that are under way, including the following:

- Inspection-related matters:
  - Reorganization of the inspections group under the leadership of Helen Munter, PCAOB director of registration and inspections.
  - The PCAOB's goals, in 2012, to increase its focus on the quality-control function of global audit networks and to perform inspections in more countries, partly as a result of cooperative agreements reached with certain regulators outside the United States.
- The aim of recent meetings with Chinese officials to strengthen ties between the two countries regarding the oversight of public-company audits.
- The PCAOB's plan to issue additional Rule 4010<sup>1</sup> reports, including one on audits of internal control over financial reporting; such reports contain summaries or compilations of the PCAOB's various inspection findings and are released as the Board deems appropriate.

### Standard-Setting Agenda

In addition, Chief Auditor Marty Baumann gave an update on the PCAOB's various standard-setting activities and reviewed its future standard-setting agenda. On the basis of its updated standard-setting [agenda](#), the PCAOB expects to do the following by December 2012:

- Issue proposed standards on the following topics for public comment:
  - The auditor's reporting model.

<sup>1</sup> PCAOB Rule No. 4010, *Board Public Reports*.

Overall feedback on the PCAOB's proposed concept release has indicated that most commenters do not favor use of mandatory firm rotation to enhance auditor independence, objectivity, and professional skepticism.

- Considerations when part of the audit is performed by other auditors.
- Assignment and documentation of firm supervision responsibilities.
- Codification framework for PCAOB standards.
- Auditing fair value.
- Use of specialists.
- Consideration of going-concern matters.
- Reexpose or adopt final standards on the following topics:
  - Audit transparency — identification of the engagement partner and other public accounting firms or persons involved in the audit.
  - Audits of broker-dealers.
  - Audit confirmations.
  - Related parties, significant unusual transactions, and executive compensation.
  - Communications with audit committees.

Another significant project on the PCAOB's agenda is its August 2011 [concept release](#)<sup>2</sup> on auditor independence and audit firm rotation. Comments on the concept release were due by December 14, 2011. In addition to the input it obtained through the comment letter process (more than 650 comment letters were received on the concept release), the PCAOB held a roundtable in March 2012 to gather further input. Overall feedback has indicated that most commenters (e.g., audit firms, companies, and audit committees) do not favor use of mandatory firm rotation to enhance auditor independence, objectivity, and professional skepticism. Many suggested more targeted, less risky, and less costly alternatives. Chairman Doty expects that this topic will continue to be debated over the next year. The PCAOB plans to hold a second roundtable on June 28 to consider further input.

During the discussion of the PCAOB's agenda, some SAG members commented that there are too many projects on the PCAOB's current standard-setting agenda. However, Mr. Baumann stated that the PCAOB hopes to adopt standards on many of the agenda items by the end of 2013 and that he therefore is looking to add new projects to the list. One SAG member strongly believed that strengthening the audit committee (e.g., financial literacy requirements), rather than continued auditor-related standard setting, is the key to improving auditor oversight and financial reporting. In addition, some SAG members expressed concern about the recently adopted Jumpstart Our Business Startups (JOBS) Act.<sup>3</sup> Specifically, they pointed out their concern regarding differing rules and requirements for different sizes of public companies, thereby diminishing the ability of these requirements to protect investors.

## Future Topics for SAG Discussions

In its [agenda materials](#) for the SAG meeting, the PCAOB listed several topics for potential future SAG discussions or audit standard-setting projects. Of the items listed, auditing revenue recognition and audit procedures related to detecting fraud were the topics that SAG members believed deserved the highest priority. Auditing revenue recognition was thought to be a high priority because revenue is a topic that analysts focus heavily on. In addition, the FASB is considering revising its accounting standards on revenue recognition (see the FASB's [technical plan](#) for further details<sup>4</sup>), and many SAG members believe new auditing guidance would be helpful in light of the anticipated new accounting rules. SAG members noted that creation of a fraud center and fraud task force under the

<sup>2</sup> PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation; Notice of Roundtable*.

<sup>3</sup> For more information about the JOBS Act, see Deloitte's April 2, 2012 (updated May 8, 2012), [Heads Up](#).

<sup>4</sup> For information about the feedback that the FASB and IASB received on their joint exposure draft on revenue recognition, see Deloitte's April 13, 2012, [Heads Up](#).

For potential future SAG discussions, auditing revenue recognition and audit procedures related to detecting fraud were the topics that SAG members believed deserved the highest priority.

PCAOB would be consistent with recommendations from the [Advisory Committee on the Auditing Profession \(ACAP\)](#).<sup>5</sup> SAG members also suggested that the PCAOB interview (1) parties who have identified fraud and (2) professionals from the Association of Fraud Examiners in order to consider and develop additional procedures that auditors may perform to help detect fraud.

A few SAG members expressed their support for reconsidering the audit standard related to non-compliance with laws and regulations (the extant standard on this topic is AU Section 317<sup>6</sup>). One SAG member believed that the PCAOB should further consider some of the detailed aspects of the auditor independence standards. Another SAG member noted that *annual* financial statement audits may be less relevant in a world in which investors are focusing on real-time information. This member suggested that the Board consider providing guidance on quarterly or continuous auditing.

Regarding topics for future consideration, SAG members discussed the need for the Board to carefully define the problem that it is trying to solve before embarking on a project. Thus, the Board would be focusing on the root cause of an existing problem.

Many SAG members noted that issuing new auditing standards is not the only way for the PCAOB to provide guidance, arguing that it is often faster to release less formal interpretations such as staff practice alerts and guides. One SAG member also suggested that it would be beneficial for the PCAOB to leverage audit firm resources to gather additional practical input and improve the efficiency of the standard-setting process.

## Going Concern

The discussion about going concern was a continuation of prior SAG discussions<sup>7</sup> on the subject in light of additional comments from the PCAOB's Investor Advisory Group and the FASB's ongoing consideration of new accounting requirements related to going concern.

FASB board member Lawrence Smith gave an update on the FASB's project on risks and uncertainties, including going concern. The FASB issued an initial exposure draft on going concern in 2008; feedback, ongoing research, and varying decisions by the FASB have resulted in multiple changes in the direction of the project — initially focusing on going concern, switching to qualitative disclosures regarding uncertainties and risks (and dropping the focus on going concern), and then returning to going concern. Most recently, the FASB has discussed defining the terms “going concern” and “substantial doubt” and requiring incremental early-warning disclosures. The FASB's [technical plan](#), as posted on its Web site, states that the Board hopes to issue an exposure draft in the fourth quarter of 2012.

During the SAG meeting, the PCAOB was asking for input from SAG members about:

- Key concepts of going concern, substantial doubt, and the look-forward period.
- A minimum set of audit procedures to identify red flags.
- Appropriate form of communication in the auditor's report on going-concern matters.

Some SAG members noted that many bankruptcies have occurred without prior auditor disclosures regarding substantial doubt about an entity's ability to continue as a going concern. These members thus believe that the bar should be lowered in determining when additional disclosure is warranted in the auditor's report. Others, however, cautioned against “overcorrecting,” which may result in auditors' disclosures about going-concern matters in most reports, leading to boilerplate language that might be ignored

<sup>5</sup> The U.S. Department of the Treasury established the ACAP “to examine the sustainability of a strong and vibrant auditing profession.” In recommendation 1 of its [final report](#), the ACAP recommends that “the [SEC], and Congress as appropriate, . . . provide for the creation by the [PCAOB] of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.”

<sup>6</sup> PCAOB AU Section 317, *Illegal Acts by Clients*.

<sup>7</sup> For more information, see Deloitte's December 16, 2011, [Heads Up](#) and April 5, 2011, [Heads Up](#).

The PCAOB is expected to issue a proposed standard on going concern during the third quarter of 2012.

or, in a worst-case scenario, might inappropriately contribute to a company's failure. Most SAG members noted that increased disclosure by management in footnotes and reference by auditors to such early-warning signals disclosed in the footnotes would be helpful to users. Accordingly, SAG members generally agreed that the PCAOB, FASB, and SEC should work together to develop guidance on appropriate criteria for management to use to determine when disclosure is necessary, the appropriate disclosures to be provided, and appropriate criteria for auditors' subsequent evaluation.

As indicated in the [Standard-Setting Agenda section](#) above, the PCAOB currently has going concern on its standard-setting agenda. It is expected to issue a proposed standard on going concern during the third quarter of 2012.

## **Related Parties, Significant Unusual Transactions, and Executive Compensation**

Another topic discussed at the meeting was the PCAOB's February 28, 2012, [proposed auditing standard](#) on related parties,<sup>8</sup> significant unusual transactions, and executive compensation. (Comments on the proposal were due by May 31, 2012.) SAG members' comments on the proposal included the following:

- The PCAOB should require auditors to perform specific procedures to identify undisclosed related parties and to test the accounting for related-party transactions.
- The standard should include additional examples of fraud risk factors specific to related parties and related-party transactions.
- Auditors should consider the existence of top-side adjustments and transactions at year-end as well as the potential involvement of related parties in such transactions.
- Auditors should consider both supporting and contradictory evidence regarding related parties and related-party transactions.
- The final standard should not imply that the auditor is required to design, or be involved in the development of, executive compensation arrangements.

The PCAOB's agenda indicates the adoption of a final standard, or the reproposal of a revised standard for public comment, is scheduled for the fourth quarter of 2012.

<sup>8</sup> For more information about the PCAOB's guidance on related parties, see Deloitte's April 10, 2012, [Heads Up](#).

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