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THE EVOLVING RESPONSIBILITIES OF AUDIT COMMITTEES, AUGUST 2013

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THE EVOLVING RESPONSIBILITIES OF AUDIT COMMITTEES*

August 2013

By Linda L. Griggs **

For many years, the audit committee has been regarded as forming a ‘‘three-legged stool” of responsible disclosure and active oversight of the financial reporting process with management and independent auditors. During the last couple of years, the Public Company Accounting Oversight Board (“PCAOB”) has increasingly focused on the role and responsibilities of the audit committee. Actions taken or proposed by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”), the U.S. Securities and Exchange Commission (the “SEC”) and the Financial Accounting Standards Board (the “FASB”) also affect audit committee performance. As a result, audit committees should ensure that they are fulfilling current regulatory and investor expectations.

This article describes recent developments that impact audit committee oversight of (i) the financial reporting system and a company’s internal control over financial reporting, (ii) independent auditors’ qualifications, independence, and performance, and (iii) risk assessment and risk management.

OVERSIGHT OF FINANCIAL REPORTING AND INTERNAL CONTROL

The New York Stock Exchange requires a listed company to have an audit committee that oversees a company’s financial reporting process, as well as the company’s internal control over financial reporting. This oversight is to be achieved through various measures, including by meeting with management and the company’s independent auditors to discuss financial statements, the adequacy of the company’s internal controls, and any material control deficiencies. Committee discussions with management may include, at least in general terms, press releases relating to the company’s earnings and other financial information, and earnings guidance provided to analysts and rating agencies. Although the NASDAQ listing standards are not as precise as the NYSE’s standards, audit committees of NASDAQ-listed companies generally assume similar responsibilities.

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* This article updates the article entitled “The Increasing Focus on Audit Committees” that appeared in the May 8, 2013 issue of The Review of Securities & Commodities Regulation.

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2 NYSE Listed Company Manual Section 303A.07(b)(i)(A)(1), Section 303A.07(b)(iii), and the General Commentary to Section 303A.07(b).

3 Nasdaq Stock Market Rule 5605(c)(3) requires audit committees to have the specific audit committee responsibilities and authority to comply with applicable provisions of SEC Rule 10A-3(b) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), which implemented Section 301 of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”). Section 301 of the Sarbanes-Oxley Act required the SEC to direct the exchanges to prohibit the listing of any company that did not comply with the requirements related to enhanced independence of audit committee members and the audit committee’s responsibilities to select, oversee, determine the compensation payable to, and evaluate the performance of the auditors, to handle complaints regarding the company’s accounting, auditing and internal controls, and to have the authority and appropriate funding to engage outside advisors. 
Active and effective oversight of the financial reporting process and a company’s internal control is also necessary for an audit committee to comply with the SEC’s requirement that the audit committee issue a report to be included in a company’s annual meeting proxy statement. This report must state whether the audit committee has, among other things, reviewed and discussed the audited financial statements with management, discussed with the independent auditors the matters required to be discussed by auditing standards, and recommended that the audited financial statements be included in the company’s annual report on Form 10-K. Various PCAOB, FASB and SEC actions during the last couple of years are either designed to enhance, or should have the effect of enhancing or, perhaps, complicating, the audit committee’s oversight of the financial reporting process and internal control.

**PCAOB Auditing Standard No. 16**

Audit committee oversight of the financial reporting process and internal control over financial reporting is enhanced by the requirements of Auditing Standard No. 16 ("AS 16"). AS 16 replaced the prior auditing standard relating to communications with audit committees, AU section 380, and is effective for audits of financial statements for fiscal years beginning on or after December 15, 2012. AS 16 retains or improves the prior communication requirements of AU section 380, incorporates the communication requirements imposed by the Sarbanes-Oxley Act, and requires new communications that are generally related to performance requirements in other PCAOB standards. In the PCAOB’s opinion, “[c]ommunications between the auditor and the audit committee allow the audit committee to be well-informed about accounting and disclosure matters, including the auditor’s evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role.” In this regard, PCAOB Chairman James Doty noted that AS 16 “is intended to foster a more robust discussion between the auditor and the audit committee” and “is intended to focus the audit committee on the importance of probing and understanding challenging audit issues and significant auditor judgments, and championing the auditor’s independence and professional skepticism in resolving those issues and making those judgments.” Chairman Doty noted that AS 16 “is an attempt to” address situations the PCAOB has seen in which audit committees do not require this kind of dialogue.

Although independent auditors have communicated to audit committees many, if not most, of the matters specified in AS 16, AS 16 improves such communications by requiring communications before the issuance of the audit opinion or the release of reviewed financial statements. In addition, AS 16 enhances the prior communication requirements by, among other things, requiring disclosure about the quality of the financial statements in the following areas:

- Accounting policies, practices, and estimates – AS 16 requires independent auditors to identify any management bias with respect to judgments about the amounts, including estimates, and disclosures in the financial statements, and to discuss (i) the quality as well as the acceptability of the company’s accounting principles, (ii) management’s selection of, or changes in, significant accounting policies or the implementation of such policies, and (iii) the effect on financial statements or disclosures of significant accounting policies in controversial areas, or areas for which there is no authoritative guidance or consensus, or diversity in practice.

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4 The audit committee’s report, required by Item 407(d)(3) of SEC Regulation S-K, must be included in proxy or information statements relating to the election of directors.

5 AS 16, “Communications with Audit Committees,” available at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_16.aspx, approved by the SEC in December 2012. A summary of AS 16 is set forth in Appendix 1 to this article.

6 Standards relating to communications by auditors with audit committees were originally adopted by the Auditing Standards Board of the American Institute of Certified Public Accountants in January 1989 in Statement on Auditing Standards No. 61 (“SAS 61”). The PCAOB included SAS 61, which was codified as AU section 380, among the interim standards that it adopted in 2003.


9 Id.
Critical accounting policies and practices – AS 16 incorporates the requirements in Rule 2-07 of SEC Regulation S-X, which were required by the Sarbanes-Oxley Act, that independent auditors communicate all critical accounting policies and practices, all alternative treatments for policies and practices related to material items that have been discussed with management, the ramifications of the use of such alternative treatments, and the treatments preferred by the independent auditors. In addition, AS 16 requires independent auditors to communicate the reasons certain accounting policies and practices are considered critical, and how current and anticipated future events might affect the determination of whether policies and practices are considered critical. AS 16 also requires independent auditors to communicate their assessment of the adequacy of management’s disclosures about critical accounting policies and practices, and any changes to those disclosures that the independent auditors proposed but management did not make.

Critical accounting estimates – AS 16 requires communications about (i) the process that management uses to develop critical accounting estimates, (ii) the significant assumptions used in critical accounting estimates that have a high degree of subjectivity, (iii) any significant changes in the process or in the assumptions, as well as management’s reasons for the changes and the effect of the changes on the financial statements, and (iv) the independent auditors’ conclusions regarding the reasonableness of the estimates. AS 16’s definition of critical accounting estimates is consistent with the SEC’s use of that term in its guidance with respect to management’s discussion and analysis of a company’s financial condition and results of operations.

Uncorrected misstatements – AS 16 requires independent auditors to (i) provide to the audit committee the schedule of uncorrected misstatements related to accounts and disclosures, (ii) discuss the independent auditors’ basis for the determination that the uncorrected misstatements were immaterial, and (iii) warn the audit committee that such uncorrected misstatements could potentially cause future-period financial statements to be materially misstated.

Significant unusual transactions – AS 16 requires independent auditors to discuss the methods used to account for significant unusual transactions and the independent auditors’ understanding of the business rationale for significant transactions that are outside the normal course of business for the company or otherwise appear to be unusual due to their timing, size, or nature.

Inquiries by independent auditors of audit committees – AS 16 requires independent auditors to inquire as to whether the audit committee is aware of matters important to the identification and assessment of risks of material misstatement, including fraud risks and violations or possible violations of laws or regulations. A company’s lawyer should counsel the audit committee so that the audit committee’s response to the inquiry does not adversely affect the availability of work product protection or the attorney-client privilege with respect to a lawyer’s views on the matter.

10 In SEC Rel. No. 33-8183 (2003), available at http://www.sec.gov/rules/final/33-8183.htm, the SEC stated that it expected that the discussion about accounting policies and practices that are determined to be critical under the SEC’s guidance would include the independent auditors’ expectations of how current and anticipated future events might affect such determinations.

11 In SEC Rel. No. 33-8350 (2003), available at http://www.sec.gov/rules/interp/33-8350.htm, the SEC explained that, in preparing disclosures about critical accounting estimates, companies should consider accounting estimates that are “material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates . . . on financial condition or operating performance is material.”

12 This required communication will be modified if the PCAOB adopts the reproposal of amendments to require independent auditors to design and perform procedures to obtain an understanding of the business purpose, if any, for each significant unusual transaction and evaluate whether the business purpose, if any, indicates that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. PCAOB Rel. No. 2013-004, “Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards” (May 7, 2013) (the “PCAOB Related Party Proposal”), available at http://pcaobus.org/Rules/Rulemaking/Docket38/Release%202013-004_Related%20Parties.pdf.
PCAOB Inspection Process

In August 2012, the PCAOB issued a release that provides guidance to audit committees about the PCAOB’s inspection process (the “PCAOB Inspection Release” or the “Release”). Among other things, the PCAOB Inspection Release explains that inspections include the examination of specific audits and may involve interviews of the audit committee, or at least the chair of the audit committee, about the particular audit. The Release suggests that audit committees ask the independent auditors whether the PCAOB inspection staff is examining the independent auditors’ audit of the company’s financial statements. If so, the Release suggests that the audit committee ask the independent auditors for information about any issues that the PCAOB inspection staff has identified with the company’s financial statements. The PCAOB Inspection Release also suggests that the audit committee ask the independent auditors whether any of the matters discussed by the PCAOB in its most recent inspection report of the independent auditors’ firm involve issues that could apply to the company’s financial statements. Discussions about these matters should assist the audit committee in overseeing the quality of the financial statements.

COSO’s Update to the Internal Control Framework

The audit committee’s oversight of the financial reporting process will also be affected by the update to the framework that is generally used by companies to evaluate their internal control over financial reporting. On May 14, 2013, COSO issued an update to its Internal Control – Integrated Framework, which was originally issued in 1992. The updated framework is intended to reflect changes since 1992 in business, stockholders’ expectations for appropriate governance oversight, the legal and regulatory environment, and the focus on the prevention and detection of fraud, and to provide more comprehensive and relevant guidance for evaluating internal control. In order to clarify and enhance the usefulness of the framework, in addition to the five integrated components of internal control in the original framework, the updated framework sets forth 17 principles to help users focus on the important aspects of each of those components. Although the updated framework includes over 80 points of focus that are important characteristics of principles, management does not have to assess whether each point of focus is in place. For example, one of the principles under the control environment component is that the board of directors, or the audit committee if it has the responsibility to oversee internal control over financial reporting, demonstrate independence from management, and exercise oversight of the development and performance of internal control. The points of focus under that principle are the establishment of oversight responsibilities, the existence on the audit committee of the requisite skills and expertise to ask probing questions of senior management and take appropriate actions, the independence of members of the audit committee, the ability of the audit committee to be objective, and the audit committee’s oversight of internal control.

The original framework will remain available during a transition period that will expire on December 15, 2014. This transition period will enable companies to make any necessary modifications to their controls or their evaluation of internal control to reflect any changes in the updated framework. Such modifications may be necessary since the updated framework provides that an effective internal control system requires that each of the five components of internal control and each of the associated principles are “present and functioning” and that the five components are operating together in an integrated manner. Audit committees should discuss the updated framework with management and the independent auditors so that they understand any changes that it will require

14 The Executive Summary of the updated framework is available at http://www.coso.org/documents/990025P_Executive_Summary_final_may20_e.pdf.
in their company’s internal control over financial reporting or their oversight of internal control over financial reporting.

**Audit of Internal Control**

Under PCAOB Auditing Standard No. 5, “An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements,” independent auditors must assess, among other things, whether the board or the audit committee understands and exercises oversight responsibility over financial reporting and internal control. As best practices evolve, the assessment of adequate oversight may also evolve, increasing the responsibility of audit committees to keep abreast of changes in best practices and in the expectations of regulators and investors of their performance.

**Focus on Management’s Discussion and Analysis**

Audit committees may need to pay even more attention to the management’s discussion and analysis of financial condition and results of operations required by Item 303 of SEC Regulation S-K (the “MD&A”) as a result of SEC developments and court decisions. During the last several years, the SEC staff has focused to a greater extent than before on the MD&A that companies include in annual reports and registration statements filed with the SEC. The MD&A is required to discuss, among other things, “known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result” in changes to the company’s liquidity, capital resources or results of operations. The staff of the Division of Corporation Finance has issued many comment letters asking companies to explain why the MD&A does not discuss various trends or uncertainties highlighted in other parts of the document, such as the risk factors, or in earnings calls. Since 2011, when the Second Circuit denied a motion to dismiss a case alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, as amended, based on the failure of The Blackstone Group, L.P. to discuss known trends or uncertainties in the MD&A, courts have reached similar decisions when they concluded that the plaintiff had plausibly alleged a failure to disclose in the MD&A a known trend or uncertainty that was reasonably likely to have a material impact on the company’s liquidity, capital resources, net sales or revenue or income from continuing operations. Further, one of the co-directors of the SEC’s Division of Enforcement noted that the SEC may focus more on the MD&A because of recent court decisions that hold that opinions, including on accounting matters, can only be subject to liability under the federal securities laws if a plaintiff plausibly alleges that the speaker subjectively disbelieved the opinion when it was made.

**PCAOB and FASB Proposals**

Various outstanding proposals of the PCAOB and the FASB, if adopted, would affect the audit committee’s oversight of the financial reporting process. These are discussed below.

**PCAOB’s Related Parties, Significant Unusual Transactions and Transactions with Executive Officers Proposal**

In the PCAOB Related Party Proposal, the PCAOB reproposed amendments that will require additional audit procedures relating to related party transactions, significant unusual transactions and compensation arrangements and other relationships and transactions with executive officers. The reproposal was designed to address the enhanced SEC approval requirement in the Jumpstart Our Business Startups Act (the “JOBS Act”). Under this requirement, the SEC must determine, prior to approving any new auditing standards adopted by the PCAOB for

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21 E.g., Fait v. Regions Financial Corporation, 655 F.3d 105 (2d Cir. 2011).
22 See note 12, supra.
compliance by emerging growth companies, that the application of the 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.” Among other things, the PCAOB Related Party Proposal would require additional discussions and communications with audit committees relating to related party transactions, significant unusual transactions and executive compensation and other arrangements with executive officers, including inquiries as to any concerns that the audit committee has with respect to any related party transactions, the business purpose of significant unusual transactions and issues relating to executive officer arrangements. These requirements are intended to further enhance the information available to audit committees, thereby enhancing their oversight of the financial reporting process.

**PCAOB’s Auditor Reporting Proposal**

On August 13, 2013, the PCAOB issued a proposal that, if adopted, would change the independent auditors’ report on a company’s financial statements. Among the proposed changes to the independent auditor’s report are proposals to require independent auditors to discuss critical audit matters and the independent auditors’ responsibilities relating to other information in an annual report filed with the SEC under the Exchange Act and to state whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact or both. If adopted, these changes to the independent auditors’ report would likely improve the quality of information available to an audit committee but may also cause delays in the completion of the independent auditors’ report and, therefore, the SEC filing. The audit committee will want to understand the critical audit matters identified by the independent auditors and discuss with management the resolution of those issues prior to the finalization of the independent auditors’ report and the financial statements. In addition, even if management resolves any material inconsistencies and material misstatements in the information outside the financial statements, the audit committee will want to understand the independent auditors’ views and ensure that the information outside the financial statements is corrected appropriately.

23 Under Section 101 of the JOBS Act, an emerging growth company is generally a public company with less than $1 billion of total annual gross revenues during its last completed fiscal year.

24 Section 104 of the JOBS Act (precluding the application of any PCAOB standards requiring mandatory audit firm rotation or a supplement to the auditor’s report to any emerging growth company and requiring the SEC to make the required determination prior to approving the application of any other new audit procedures to emerging growth companies). The PCAOB has not proposed amendments that would require mandatory audit firm rotation or a supplement to the auditor’s report. The PCAOB’s proposals relating to the auditor’s report to require additional disclosure about critical audit matters and the tenure of auditors are discussed below.


26 In Chairman Doty’s “Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information,” he noted that “[c]hanges may be incremental, as we evaluate the usefulness of improvements and, if successful, engender further change as demand for more kinds of auditor assurance grows.” Available at http://pcaobus.org/News/Speech/Pages/08132013_Doty.aspx.
FASB’s Going Concern Proposal

The audit committee’s oversight of the financial reporting process will also be more challenging if the FASB adopts its proposal relating to disclosure about uncertainties relating to a company’s ability to continue as a going concern. This proposal would require additional disclosures in the footnotes to a company’s financial statements about the company’s ability to meet its obligations if, based on management’s quarterly evaluation, management believes that either (1) it is more likely than not that the company will be unable to meet its obligations within 12 months after the financial statement date without taking actions outside the ordinary course of business or (2) it is known or probable that the company will be unable to meet its obligations within 24 months after the financial statement date without taking actions outside the ordinary course of business. Additionally, management of a company that files reports with the SEC would have to evaluate whether there is a substantial doubt about the company’s ability to continue as a going concern within 24 months after the financial statement date, considering all of management’s plans, including those outside of the ordinary course of business. If a substantial doubt exists, the company would have to disclose that determination in the footnotes to the financial statements. If the FASB adopts the proposal, audit committees are likely to be involved in the analysis of going concern uncertainties given the subjectivity of these determinations and the likely significance of the proposed disclosures to the market, shareholders, analysts, rating agencies, regulators and the company’s independent auditors.

OVERSIGHT OF THE INDEPENDENT AUDITORS

The listing standards of the NYSE and the NASDAQ require audit committees to comply with applicable provisions of SEC Rule 10A-3 under the Exchange Act, which implemented the provisions of Section 301 of the Sarbanes-Oxley Act with respect to audit committee independence and responsibilities. Among other things, the audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of the independent auditors. This section of the article discusses the impact of AS 16, the PCAOB Inspection Release and relevant SEC staff views on audit committee oversight of independent auditors. Audit committees’ oversight may also be affected by two current PCAOB projects relating to auditor independence and the identification of audit quality indicators.

Oversight of Qualifications

AS 16 requires the chairman of the audit committee, or someone on behalf of the audit committee, to sign the engagement letter, and requires the independent auditors to communicate to the audit committee information about the audit strategy, about specialized skills needed by the independent auditors to conduct the audit, and about the results of the audit. These requirements should enhance the audit committee’s evaluation of the independent auditors’ qualifications.

Oversight of Performance

The PCAOB Inspection Release suggests various questions that the audit committee should ask the independent auditors about a PCAOB inspection. Among other things, the Release suggests that the audit committee ask the independent auditors to provide the following types of information relevant to the quality of their audit when the PCAOB is examining the independent auditors’ audit of the company’s financial statements:


28 The auditing standards of the PCAOB require independent auditors to evaluate whether there is substantial doubt about a company’s ability to continue as a going concern for a reasonable period “not to exceed one year beyond the date of the financial statements being audited” and, if there is, explain this conclusion in the audit report and consider the adequacy of the company’s disclosure about the going concern uncertainty. See PCAOB AU section 341.02.

29 See note 3, supra.
whether the PCAOB inspection staff has suggested that the independent auditors’ audit opinion on
the company’s financial statements was not sufficiently supported, or that the independence or
performance of the independent auditors was not adequate; and

whether the independent auditors are taking any remedial steps to address any quality control
concerns identified by the PCAOB inspection staff with respect to the company’s audit and, if
so, the status of such remedial action.

The PCAOB Inspection Release also suggests questions that audit committees should ask about matters
discussed in the PCAOB’s inspection report on the independent auditors’ firm, as well as in any PCAOB
summaries of inspection reports. For example, the audit committee should ask the independent auditors whether any
of the matters discussed by the PCAOB in the inspection report on the independent auditors’ firm or in PCAOB
summaries of inspection reports involve issues or audit approaches similar to those that arise or could arise in the
audit of the company’s financial statements and, if so, how the independent auditors have become comfortable that
the same or similar deficiencies did not occur in the audit of the company’s financial statements or have been
remediated.

The PCAOB Inspection Release also discusses various assertions made by independent auditors’ firms with
respect to audit deficiencies found by the PCAOB inspection staff. For example, independent auditors’ firms
sometimes express disagreement with a PCAOB finding that the independent auditors did not perform certain
procedures. The Release explains that the PCAOB does not comment that audit procedures were deficient in
obtaining audit evidence when the PCAOB simply found inadequate documentation. In addition, sometimes
independent auditors’ firms assert that a PCAOB criticism in an inspection report related to a difference of
professional judgment. The Release explains that the PCAOB does not comment when an independent auditors’ firm
had a reasonable basis for the firm’s audit opinion. The Release suggests that audit committees ask how the firm
concluded that the non-documented procedures were performed, why they were not documented, and why the
PCAOB inspection staff was not satisfied. With respect to professional judgment, audit committees should ask the
independent auditors to identify the point of professional judgment at issue, defend the firm’s judgment on that point,
and explain why the inspection staff rejected the firm’s position.

Oversight of Independence

Another audit committee responsibility that audit committees should re-examine is the responsibility to approve
services being performed by the independent auditors. Rule 2-01 of SEC Regulation S-X, which relates to the
qualifications of independent auditors, requires the audit committee to approve in advance all services being
performed by the auditors. The pre-approval requirement was added to Section 10A of the Exchange Act by Section
202 of the Sarbanes-Oxley Act. Rule 2-01 requires pre-approval of all audit, review, attest, and non-audit services,
and provides that any pre-approval policies and procedures established by the audit committee to implement the
requirement must be specific as to the particular services. The SEC staff has explained that the audit committee
must know “precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment
of the impact of the service on the auditor’s independence.” At “The SEC Speaks” conference in February 2013,
the Chief Counsel of the SEC’s Office of the Chief Accountant suggested that audit committees should require that
their pre-approval policies and procedures are sufficiently detailed to ensure that the audit committee is appropriately
approving all services being performed by the independent auditors and has not inappropriately delegated to
management the determination whether a service has been pre-approved.

PCAOB Independence Project

30 Rule 2-01(c)(7)(i) of SEC Regulation S-X.
31 Question 5 under “Audit Committee Pre-approval,” Office of the Chief Accountant, “Application of the Commission’s Rules on Auditor
In 2011, the PCAOB issued a concept release that requested comment on ways that auditor independence, objectivity and professional skepticism could be enhanced. This concept release invited comment specifically on the merits of mandatory audit firm rotation, perhaps every ten years or for only the largest issuer audits. The PCAOB held several public meetings to discuss this topic and has received many negative comments on mandatory rotation. While a final decision on mandatory rotation is not likely for a while, the PCAOB’s proposed amendments to the independent auditors’ report would require disclosure of, among other things, the length of time that the independent auditors’ firm has audited the company’s financial statements and a statement regarding the requirements that the independent auditors be independent with respect to the company. Even if the proposed amendments are not designed to affect the audit committee’s consideration of re-engaging the auditor, audit committees may take tenure into account if it is publicly disclosed in the independent auditors’ report.

**PCAOB Audit Quality Indicators**

The PCAOB’s Strategic Plan for 2012-2016, which the PCAOB issued in November 2012 (the “Strategic Plan”), identified as a priority project for 2013 its project to develop audit quality measures. One of the objectives of this project is to provide audit committees, among others, with tools they can use to evaluate their auditors. The PCAOB staff has defined audit quality as performance that meets ‘investors’ needs for independent and reliable audits and robust audit committee communications on:

1. financial statements, including related disclosures;
2. assurance on internal control; and
3. going concern warnings.

The PCAOB staff is considering possible audit quality measures in the following areas:

- audit inputs (related to the need for competent and talented people to conduct the audit, including operational factors such as workloads, industry expertise, and data on hours devoted by various professionals or topics);
- the audit process (which includes the factors from the PCAOB’s quality control standards and COSO’s internal control framework and include tone at the top, PCAOB inspection findings, compensation data, and leverage); and
- audit results (which include the frequency and market impact of financial statement restatements for errors, the number and percentage of unqualified internal control over financial reporting opinions with material errors in the following year, information about opinions noting material weaknesses or going concern issues, and surveys of audit committee members’ views on the quality of communications from the auditors).

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33 See note 26, supra.
34 PCAOB “Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors, 2012-2016” (November 30, 2012), available at http://pcaobus.org/About/Ops/Documents/Strategic%20Plans/2012-2016.pdf. Other 2013 priorities include improving the timeliness, content and reliability of inspection reports and the analysis and usefulness of the PCAOB inspections and enhancing the PCAOB’s outreach to and interaction with audit committees.
36 Id. at 3-4,
In addition, the PCAOB staff is considering whether the audit quality measures should be based on the engagement team, an office or region, affiliate firm or global firm. Although this project is in its early stages, the possible audit quality measures being considered by the PCAOB staff may be relevant to the audit committee’s evaluation of the performance of the auditor.

OVERSIGHT OF RISK ASSESSMENT AND RISK MANAGEMENT

The role of the board of directors to oversee a company’s identification and control of risks has received significant attention since the financial crisis that prompted the U.S. Congress to pass the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) in 2010.37 Although, since 2004, the NYSE has required an audit committee of a listed company to discuss with management guidelines and policies with respect to the process by which the company assesses and manages the company’s risks, the NYSE does not require the audit committee to be solely responsible for risk oversight.38 Nevertheless, many companies rely on the audit committee to take the primary responsibility for risk oversight, including by overseeing the delegation of specific risk areas to other board committees.

As a result of the financial crisis, the need for more rigorous board oversight of risks became evident, resulting in additional SEC disclosure requirements and additional risk oversight guidance from COSO. In 2009, the SEC adopted a requirement that public companies disclose in proxy or information statements relating to the election of directors the extent of the board’s role in risk oversight, such as how the board administers its oversight function, and the effect that this has on the board’s leadership structure.39 COSO has issued thought papers related to risk management oversight that supplement COSO’s “Enterprise Risk Management – Integrated Framework,” which COSO issued in 2004.40 The first paper, issued in 2009, “Effective Enterprise Risk Oversight: The Role of the Board of Directors,”41 suggests that boards, or a delegated board committee, like the audit committee, adopt COSO’s framework for enterprise risk management to satisfy the demands for greater board risk oversight. It summarizes the following responsibilities for boards in enterprise risk management:

- understand an entity’s risk philosophy and agree on an appropriate level of risk for the entity;
- challenge management to demonstrate the effectiveness of the processes for identifying, assessing, and managing the entity’s most significant risk exposures; and
- understand and assess an entity’s strategies to manage risk exposures; and

37 Section 165(h) of the Dodd-Frank Act provides that the Board of Governors of the Federal Reserve System must require the establishment of a board risk committee by each non-bank financial company supervised by the Board of Governors that is a publicly traded company and each bank holding company that is publicly traded and has total consolidated assets of not less than $10 billion.

38 The commentary to Section 303A.07(b)(iii)(D) in the NYSE Listed Company Manual, which requires the audit committee to “discuss policies with respect to risk assessment and risk management,” states as follows:

While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.


obtain, on a regular basis, information regarding new risks and how management is addressing such new risks.

“Board Risk Oversight – a Progress Report – Where Boards of Directors Currently Stand in Executing Their Risk Oversight Responsibilities”

reported in 2010 the results of a survey of board members’ perceptions of board oversight of risk, and set forth recommendations for ways that boards can improve the effectiveness of their oversight. Among these recommendations are that a board implement a structured process for its oversight of risk, including through at least annual board evaluations of whether business changes require reassessment of the critical assumptions and inherent risks in the entity’s strategy, and periodic reporting by management about critical enterprise risks.

In March 2012, COSO issued guidance intended to enhance the board’s evaluation of management’s judgments, including those related to the assessment and management of risks. “Enhancing Board Oversight – Avoiding Judgment Traps and Biases” presents a suggested framework for the exercise of judgment and suggests ways to address common threats to the application of that framework, such as overconfidence, the rush to solve a problem, the tendency to try to avoid conflict, and the tendency to not explore all alternatives. Most recently, in October 2012 and May 2013, COSO issued two additional thought papers, “Risk Assessment in Practice,” which discusses risk assessment approaches and techniques that COSO believes are “the most useful and sustainable for decision-making” and “Demystifying Sustainability Risk,” which discusses how the COSO Enterprise Risk Management Framework can be used to address the increasing need for companies to take into account the environment and social impact of the products and services they sell and offer.

To the extent that an audit committee has responsibility for risk oversight, the committee should consider discussing COSO’s guidance with management to determine whether the company’s risk assessment and risk management should be enhanced to adopt any of the analytical steps identified in COSO’s “Risk Assessment in Practice” paper. The audit committee should evaluate whether it should take additional steps or change any of its activities to oversee risk assessment and risk management more effectively.

CONCLUSION

The audit committee is a critical part of the “three-legged stool” that represents the financial reporting process. Because of the PCAOB’s view that the audit committee’s oversight of the financial reporting and audit process is a key role in governance, the PCAOB identified in its Strategic Plan six near-term priorities, including enhancing its “outreach to and interaction with audit committees to constructively engage in areas of common interest, including auditor independence and audit quality.” Any such interaction or actions by the SEC, COSO, the FASB or others could result in additional best practices relating to audit committee performance. Accordingly, audit committees must monitor and adopt such best practices as they evolve. Lawyers should assist audit committees with these efforts by informing them of developments that affect their responsibilities and encouraging them to discuss the developments among themselves, with management, and with the independent auditors.

45 See note 34, supra.
SUMMARY OF AUDITING STANDARD NO. 16, “COMMUNICATIONS WITH AUDIT COMMITTEES”

Auditing Standard No. 16, “Communications With Audit Committees,” which the SEC approved on December 16, 2012 (“AS 16”), identifies the objectives of the communication requirements and requires independent auditors to communicate to audit committees, prior to the issuance of an audit report or the filing of reviewed interim financial statements, information about the audit or review engagement and the results of such engagement.

The objectives of the communication requirements are for independent auditors to do the following:

- communicate to the audit committee the auditor’s responsibilities with respect to the audit and establish an understanding with the audit committee as to the terms of the audit engagement;
- obtain information from the audit committee relevant to the audit;
- communicate to the audit committee information about the audit strategy and the timing of the audit; and
- provide to the audit committee timely observations arising from the audit that are significant to the financial reporting process.

The communication requirements address the following areas:

- Appointment and retention of the independent auditor
  - The independent auditor should communicate any significant issues discussed with management in connection with the auditor’s appointment or retention.
  - The independent auditor should communicate information about the audit to establish an understanding with the audit committee of the terms of the audit engagement.
  - The independent auditor should ensure that the annual engagement letter is either signed by the audit committee or its chair on behalf of the audit committee or that the audit committee has agreed to the terms of the engagement.

- Obtaining information and communicating the audit strategy
  - The independent auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit, including violations or possible violations of laws or regulations.
  - The independent auditor should communicate information to the audit committee about the overall audit strategy, including the timing of the audit, and significant risks identified by the independent auditor during its risk assessment procedures. With respect to strategy, the communication should include information about these topics:
    - any need for specialized skills or knowledge to conduct the audit;
    - any expectation that work of other persons (e.g., internal auditors) will be used; and
    - any changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.
Results of the audit

- The independent auditor should communicate to the audit committee information, including its assessments and conclusions, about the following:
  - significant accounting policies and practices;
  - critical accounting policies and practices;
  - critical accounting estimates;
  - significant unusual transactions;
  - financial statement presentation;
  - new accounting pronouncements; and
  - alternative accounting treatments.

- The independent auditor should communicate information about the following additional matters:
  - its review of information outside of the audited financial statements;
  - any consultations that the independent auditor made with persons outside the audit team on difficult or contentious matters that are relevant to the audit committee’s oversight of the financial reporting process;
  - any consultations by management with other accountants about significant auditing or accounting matters if the independent auditor has a concern regarding any such matter;
  - the independent auditor’s evaluation of the company’s ability to continue as a going concern if the independent auditor believes, or believed, that there is, or was, a substantial doubt about the company’s ability to continue as a going concern;
  - uncorrected and corrected misstatements;
  - material written communications between the independent auditor and management;
  - departures from the standard auditor’s report;
  - any disagreements with management, whether or not satisfactorily resolved, that could be significant individually or in the aggregate;
  - difficulties encountered during the performance of the audit, including significant delays by management; and
  - any other matters that the independent auditor believes are significant to the audit committee’s oversight of the financial reporting process.

The independent auditor does not need to provide the information in writing to the audit committee but it must document the communication in its work papers.
SUMMARY OF THE PCAOB’S “INFORMATION FOR AUDIT COMMITTEES ABOUT THE PCAOB INSPECTION PROCESS”

The PCAOB’s goal in issuing PCAOB Release No. 2012-003, “Information for Audit Committees About the PCAOB Inspection Process” (August 1, 2012) (the “PCAOB Release”), was to enhance the quality of the independent auditors’ discussion about the PCAOB inspection results with an audit committee so as to improve the audit committee’s oversight and evaluation of the audit engagement and the audit committee’s role in the oversight of the financial reporting process.

The PCAOB Release does the following:

- describes the PCAOB’s inspection process and the types of information in the inspection report;
- suggests questions that audit committee members can ask their independent auditors about (i) the PCAOB inspection, including whether the independent auditors’ audit of their company is being inspected, and (ii) the inspection report, including questions about some of the typical assertions that independent auditors give in response to the inspectors’ findings (such as the deficiency was just a documentation issue); and
- observes that independent auditors are not prohibited from discussing the inspection report with the audit committee, including the non-public part, and the audit committee should not accept an independent auditors’ assertion to the contrary.

The purpose of an inspection is for the PCAOB to assess the auditing firm’s compliance with certain laws, rules, and professional standards in connection with its work for public companies. Auditing firms that audit more than 100 issuers are inspected every year. Others are inspected every three years.

Inspections are designed to identify and address weaknesses and deficiencies related to how independent auditors conduct audits through the following:

- reviews of certain aspects of selected audits performed by independent auditors; and
- evaluation of the design and operating effectiveness of auditing firms’ quality control policies and procedures.

The PCAOB identifies specific audits for examination based on the PCAOB’s analysis of factors that, in the PCAOB inspection staff’s view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample of the independent auditors’ work. The areas of focus on the selected audits often involve audit work on the most difficult or inherently uncertain areas of the financial statements.

As a part of the examination of an audit, the inspection staff may interview the chairman of the audit committee of the company whose audit is part of the inspection. In addition, the inspection staff routinely communicates inspection information to the SEC on an issuer-specific basis, including information about audit deficiencies, possible material misstatements of financial statements, potential auditor independence issues, and any other apparent violations of the federal securities laws. Generally, the inspection staff should raise any of these issues with the independent auditors first and the independent auditors are free to discuss these issues with the audit committee.
The auditing firm can seek non-public review by the SEC of the final inspection report if the firm disagrees with any of the assessments in the final report. The PCAOB will give to the SEC the final report as well as the names of all of the companies whose audits were reviewed.

The PCAOB’s inspection report consists of two parts: Part I, which is public, and Part II, which is not public unless the auditing firm fails to satisfy the PCAOB that it has remediated any problems discussed in Part II within 12 months of issuance of the inspection report. The independent auditors are not prohibited from releasing Part II of the inspection report even though the PCAOB cannot make it public.

Part I of an inspection report (i) describes audit deficiencies, that is, the inspection staff’s conclusion that the independent auditors failed to gather sufficient audit evidence to support an audit opinion on either the financial statements or a company’s internal control over financial reporting and (ii) includes the auditing firm’s response to the deficiencies identified in Part I of the report to the extent the auditing firm chooses to have its response made public. If the PCAOB inspection staff reaches a conclusion that there is an apparent material misstatement in a set of financial statements, the report will summarize the inspection staff’s criticism of the auditing in terms that reflect the inspection staff’s view that the financial statements are misstated. The inspection staff does not engage with the company’s management, however, and the inspection report conclusion does not suggest what the SEC might do, if anything, with respect to any finding that financial statements are misstated.

Part II of an inspection report describes deficiencies in the auditing firm’s overall system of quality control when the PCAOB has doubts that the system provides reasonable assurance that professional standards are met. Criticisms of an auditing firm’s quality control may focus on a specific aspect of the audit work, such as deficiencies in the audit of management’s estimates or revenue recognition, or may be more general, such as concerns about supervision and review or the firm’s management structure and processes. If the inspected auditing firm does not address to the PCAOB’s satisfaction the criticisms in Part II of the inspection report within twelve months after the issuance of the inspection report, the PCAOB makes the criticisms public.

The PCAOB Release suggests various questions that audit committees should ask independent auditors. With respect to the inspection process itself, the audit committee should ask whether the inspection staff has selected the company’s audit for inspection. If the inspectors are looking at the company’s audit, the audit committee should request timely information both during the inspection and when the PCAOB has issued a final inspection report. The types of information the audit committee can ask the independent auditors to provide about the inspector’s examination of the company’s audit are the following:

- whether anything suggests that the independent auditors’ audit opinion on the company’s financial statements is not sufficiently supported or reflects negatively on the auditors’ performance of the audit;
- whether a question has been raised about the fairness of the financial statements or the adequacy of the disclosures;
- whether the independent auditors agree with any such questions or concerns about their audit and if not, why not;
- whether a question has been raised about the auditors’ independence; and
- whether the independent auditors are taking any remedial steps to address quality control concerns identified in the company’s audit, and, if so, the status of such remedial action and whether the independent auditors expect to respond to the inspection report before the 12-month deadline.

The types of questions audit committees may want to ask about the inspection report and any PCAOB summaries of inspection reports are the following:
whether any of the matters described in Part I of the inspection report 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 independent auditors have 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;

whether the independent auditors are making any changes to their policies and procedures to reduce the chance that the types of deficiencies identified in other audits will arise in audits of the company’s financial statements and, if so, whether the independent auditors expect to respond to the inspection report before the 12-month deadline; and

with respect to issues described by the PCAOB in general reports summarizing inspection results across groups of auditing firms, whether any of such issues relate to the independent auditors’ practices, and potentially the audit of the company’s financial statements, and how the independent auditors are addressing those issues.

Since auditing firms may include in Part I of the inspection report various responses to the inspectors’ observations, the PCAOB’s statement suggests certain questions that audit committees should ask about certain auditing firm assertions that may appear in Part I. For example:

- If the auditing firm asserted that a deficiency is simply a function of inadequate documentation of its audit work, the audit committee may want to discuss how the firm concluded that the non-documented procedures were performed, why they were not documented, and why the inspection staff was not satisfied. In this regard, the PCAOB explains that it does not make a comment that the audit procedures were deficient in obtaining audit evidence when there is simply inadequate documentation.

- If the auditing firm asserted that a particular criticism in the inspection report was a function of a difference of professional judgment, the audit committee should ask the independent auditors to identify the point of professional judgment at issue, defend the firm’s judgment on that point, and explain why the inspection staff rejected the firm’s position. The PCAOB explains that it would not make the comment that there was insufficient audit evidence if it agreed that the omitted procedures were unnecessary and that the independent auditors had a reasonable basis for their audit opinion. In addition, the PCAOB explains that it bases deficiency findings only on failures to obtain sufficient audit evidence, not on disagreements when reasonable judgments appear to have been made about such matters.

- If the auditing firm asserted that it addressed a criticism as required under PCAOB standards, the audit committee should ask the independent auditors whether the firm believes its opinion was sufficiently supported at the time it was originally issued (that is, the auditing firm disagrees with the inspection report’s description of a deficiency) or whether the independent auditors obtained additional audit evidence through additional auditing procedures, possibly including procedures performed in subsequent audits, that support its prior opinion. The PCAOB explains that it only includes a finding of a failure to obtain sufficient audit evidence when the inspection staff has not found that the independent auditors performed sufficient procedures to support the opinion. If the auditing firm asserts that it has addressed the criticism, that could mean either that the independent auditors performed additional procedures in response to the finding or in subsequent audits or that the firm disagreed with the finding that additional procedures were necessary.
With respect to Part II of the inspection report, the audit committee should ask the following questions:

- What changes is the auditing firm making to address any quality control deficiencies?
- What is the progress of the quality control remediation process and what submissions has the auditing firm made to the PCAOB as part of the process?
- What are the years covered by the PCAOB’s most recent evaluation of the auditing firm’s remediation efforts and the nature of that evaluation, including whether the PCAOB has provided any initial indications that the firm may not have sufficiently remediated any items?