

## ADVISORY | Securities

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### REQUIRED COMMUNICATIONS BETWEEN AUDITORS AND AUDIT COMMITTEES

The Public Company Accounting Oversight Board (“PCAOB”) recently adopted Auditing Standard No. 16, *Communications with Audit Committees* (“AS No. 16”), a new standard for audit firm communications with the audit committees of public companies.<sup>1</sup> The new audit standard is intended to encourage “effective two-way communication between the auditor and the audit committee throughout the audit to assist both parties in understanding matters relevant to the audit.”<sup>2</sup> Upon approval by the SEC last month, the standard became effective for audits for fiscal years beginning after December 15, 2012 and supersedes and expands the PCAOB’s previous interim standards governing audit firm communications with audit committees.

Below, we discuss some background related to the new standard, describe the timing and form of the communications that audit firms must make, summarize the elements of the communications required by the new standard, and discuss implications of the new standard for audit committees and management.

#### BACKGROUND

The Sarbanes-Oxley Act of 2002 (“SOX”) contained a number of reforms intended to improve the integrity of accounting and financial disclosure. Three key provisions of the Act (1) established the PCAOB to oversee the audits of public companies, (2) made the PCAOB responsible for promulgating audit standards applicable to the audits of public companies, and (3) enhanced the independence and role of the audit committee, in part by requiring that the audit committee have the ultimate responsibility for selecting the auditor and overseeing a public company’s accounting and financial reporting process.

In 2003, the PCAOB adopted pre-existing generally accepted audit standards as interim PCAOB standards<sup>3</sup>, including two standards governing what audit firms must communicate to their clients and the audit firm engagement process, respectively.<sup>4</sup> AS No. 16 supersedes these two interim standards and reflects the PCAOB’s views of what communications should be required between audit firms and audit committees in light of the enhanced role of the audit committee under SOX.

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<sup>1</sup> See *Auditing Standard No. 16 - Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*, PCAOB Rel. No. 2012-004 (Aug. 15, 2012) (the “[Adopting Release](#)”). The Securities and Exchange Commission (“SEC”) approved the new standard on December 17, 2012. See *Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules on Auditing Standard No. 16, Communications with Audit Committees, and Related and Transitional Amendments to PCAOB Standards*, SEC Rel. No. 34-68453 (Dec. 17, 2012).

<sup>2</sup> Adopting Release at 3.

<sup>3</sup> The interim standards consist of generally accepted auditing standards as described in the AICPA Auditing Standards Board’s Statement of Auditing Standards No. 95, as in existence on April 16, 2003. Under the PCAOB’s Rule 3200T, all such standards apply as interim standards to the extent not superseded or amended by the PCAOB.

<sup>4</sup> These interim standards are AU sec. 380, *Communications with Audit Committees* and AU sec. 310, *Appointment of the Independent Auditor*.

Although it restates many of the requirements that were part of the superseded interim standards, the new standard also makes a number of changes that will alter both the content and structure of communications between audit firms and audit committees.<sup>5</sup>

## TIMING AND FORM OF COMMUNICATIONS

The previously applicable standards stated that audit committee communications are incidental to the audit and not required to occur before the issuance of the auditor's report. The new standard elevates the importance of communications with the audit committee and requires that they take place on a "timely basis" and prior to the issuance of the auditor's report. The timing of particular communications is likely to vary depending on the significance of the matter and any corrective or follow-up actions needed. Although the rule does not require the audit firm to communicate with the audit committee more than one time each year, it does suggest that more frequent communication will often be appropriate. Communications about the terms of the audit engagement and the audit strategy may have the greatest relevance early in the audit process, whereas communications about the audit firm's evaluation of the firm's financial statements will necessarily take place closer to the issuance of the audit report.

The communication between the audit firm and the audit committee may be oral or in writing. The stated purpose of the standard is to promote effective two-way communication between the audit firm and the audit committee, and the PCAOB has indicated that the appropriate form and timing of the communication may depend on the nature of the matter to be communicated. AS No. 16 provides that the audit firm may communicate with the chair of the audit committee rather than the committee itself in order to communicate matters in a timely manner during the audit, so long as the audit firm also communicates such matters to the committee before the audit report is issued.

## ELEMENTS OF REQUIRED COMMUNICATIONS

Below, we outline the communications required by the new standard. Broadly speaking, the required communications cover (1) the company's engagement of the audit firm, (2) inquiry of the audit committee about matters relevant to the audit, (3) the audit strategy and approach, including accounting policies, practices and estimates, (4) significant unusual transactions identified by the audit firm, and (5) the audit firm's evaluation of the company's financial reporting and other key findings related to the audit.

### The company's engagement of the audit firm

**Discussions with management in connection with appointment or retention.** The new standard requires the audit firm to discuss with the audit committee any significant issues that the audit firm discussed with management in connection with the audit firm's appointment or retention, including any significant discussions regarding the application of accounting principles and auditing standards. Although under SOX the audit committee has responsibility for appointment or retention of the audit firm, the rule acknowledges that it may rely on management in making its decision. The purpose of this requirement seems to be to help the audit committee determine whether management's recommendations may have been influenced by its discussions with the audit firm about how accounting principles or auditing standards would be applied.

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<sup>5</sup> In addition to AS No. 16, the PCAOB issued guidance in August 2012 regarding audit firm communications with audit committees about PCAOB inspection results, encouraging audit committees to ask about, and audit firms to discuss, the results of inspections that the PCAOB conducts of audit firms. See *Information for Audit Committees about the PCAOB Inspection Process*, PCAOB Rel. No. 2012-003, (Aug. 1, 2012).

**Terms of the audit and engagement letter.** The new standard requires the audit firm to establish an understanding of the terms of the audit with the audit committee. While the interim standards already required an audit firm to establish such an understanding with the “client,” the new standard makes it clear that this understanding is to be with the audit committee. The audit firm must record this understanding in an engagement letter that includes the objective of the audit and the responsibilities of the audit firm and management. The engagement letter must be executed by “the appropriate party or parties,” and, if this is not the audit committee or its chair, then the audit firm must determine that the audit committee has acknowledged and agreed to the terms of the engagement.

### **Inquiring of the audit committee about matters relevant to the audit**

The new standard requires the audit firm to ask the audit committee whether it is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations. This requirement is in addition to the existing requirement that the audit firm make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risk.<sup>6</sup> While the standard does not specify the timing of these inquiries, the PCAOB notes that they may be appropriate both at the outset of the audit and as the audit progresses.<sup>7</sup>

### **Audit strategy and accounting policies, practices and estimates**

**Audit strategy.** The new standard requires the audit firm to communicate to the audit committee an overview of the audit strategy, including the timing of the audit and the “significant risks” identified during the auditor’s risk assessment procedures.<sup>8</sup> As part of this communication, the audit firm must communicate specifically with respect to the following:

- specialized skill or knowledge that will be required to perform procedures or evaluate audit results related to significant risks;
- the extent to which the audit firm will rely on the company’s internal auditors in connection with an audit of financial statements or the company’s internal auditors, other company personnel or third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting; and
- the names, locations and planned responsibilities of other audit firms, or others not employed by the audit firm, that perform audit procedures in the current period audit.<sup>9</sup>

**Accounting policies, practices and estimates.** The new standard requires the audit firm to communicate with the audit committee regarding the company’s most important accounting policies, practices and estimates in the following ways.

- *Significant accounting policies and practices* include those that are required to be described as part of the company’s financial statements. The audit firm must communicate with the audit committee regarding management’s initial selection of, or changes in, significant accounting policies or the application of such policies in the current period and the effect on financial

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<sup>6</sup> Auditing Standard No. 12 - Identifying and Assessing Risks of Material Misstatement (“AS No. 12”), paragraphs 5.f and 54-57. See PCAOB Rel. No. 2010-0004 (Aug. 5, 2010).

<sup>7</sup> Adopting Release at A4-8.

<sup>8</sup> “Significant risks” are risks of material misstatement that require special audit consideration. AS No. 12, paragraph A5.

<sup>9</sup> If significant parts of the audit are to be performed by other auditors, the audit firm must communicate to the audit committee the basis of its determination that it can serve as principal auditor. AS No. 16, paragraph 10.e.

statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity of practice.

- *Critical accounting policies and practices* are those that “are both most important to the portrayal of the company’s financial condition and require management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.” Under the Securities Exchange Act of 1934 , the audit firm must communicate to the audit committee all critical accounting policies and practices to be used.<sup>10</sup> The new standard also requires the audit firm 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 certain policies and practices are considered critical.
- *Critical accounting estimates* are accounting estimates where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters and (b) the impact of the estimate on financial condition or operating performance is material. The new standard requires the audit firm to communicate: (1) the process management used to develop critical accounting estimates; (2) management’s assumptions in developing critical accounting estimates that are significant and have a high degree of subjectivity; and (3) any significant changes management made to (1) or (2), a description of management’s reasons for the changes and the effect of the changes on the financial statements.

The new standard acknowledges that in many cases, management will communicate with the audit committee regarding the company’s accounting policies, practices and estimates. To avoid duplication, the audit firm may satisfy the communication requirement if it participates in management’s discussion with the audit committee, confirms that management has adequately communicated the required matters and identifies for the audit committee those accounting policies and practices that the audit firm considers critical.

### Significant unusual transactions

The new standard requires the audit firm to communicate with the audit committee regarding significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size or nature, and the policies and practices management used to account for significant unusual transactions. The PCAOB has suggested that the purpose of this requirement is not only to identify significant risks related to significant unusual transactions but also to improve oversight of the financial reporting process in light of concerns that significant unusual transactions have at times been considered a contributing factor in attempts to mislead investors about a company’s financial condition. To the extent management has communicated with the audit committee regarding significant unusual transactions, the audit firm need not communicate the information at the same level of detail, but must communicate any omitted or inadequately described matters.

### Audit firm’s evaluation of the company’s financial reporting and other findings

**Evaluation of the quality of the company’s financial reporting.** The new standard requires the audit firm to communicate with the audit committee the following points regarding the audit firm’s views of the company’s financial reporting:

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<sup>10</sup> Sec. 10A(k) of the Exchange Act, 15 U.S.C. § 78j-i(k); see also SEC Rule 2-07 of Reg. S-X, 17 C.F.R. § 210.2-07.

- the audit firm's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations where the audit firm identified bias in management's judgments, and the audit firm's evaluation of the differences between the estimates best supported by audit evidence and estimates included in the financial statements that indicate possible management bias;
- the audit firm's assessment of management's disclosures related to critical accounting policies and practices, and any significant modifications to the disclosures of those policies and practices proposed by the auditor that management did not make;
- the basis for the audit firm's conclusions regarding the reasonableness of the critical accounting estimates;
- the audit firm's understanding of the business rationale for significant unusual transactions;
- the results of the audit firm's evaluation of whether the presentation of the financial statements and related disclosures conform with the applicable financial reporting framework;
- concerns identified by the audit firm regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective; and
- alternative accounting treatments for material items that have been discussed with management, and the treatment preferred by the audit firm.

**Other reporting on the audit process and findings.** In addition to the evaluation of the company's financial reporting described above, the audit firm must communicate, when relevant, the following regarding the process and results of the audit.

- the audit firm's responsibility for information other than financial statements that is presented in documents containing audited financial statements;
- difficult or contentious matters for which the auditor consulted outside the engagement team (for example, with the firm's national office or industry specialists);
- management's consultation with other accountants about significant auditing or accounting matters where the audit firm has identified a concern with such matters;
- conditions and events the audit firm has identified that, when considered in the aggregate, lead the auditor to believe that there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time;
- the schedule of uncorrected misstatements relating to accounts and disclosures that was presented to management, and any non-trivial corrected misstatements that might not have been detected except through the auditing procedures performed;
- other material written communications between the auditor and management;
- modifications to the audit firm's standard report, including the reasons for and wording of the modification, explanatory language or explanatory paragraph;
- 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 audit firm's report;
- significant difficulties encountered during the audit, such as delays or lack of cooperation from management or an unreasonably brief time to complete the audit; and

- other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns that have been conveyed to the audit firm in the course of the audit.

## IMPLICATIONS FOR AUDIT COMMITTEES AND MANAGEMENT

Given the responsibility of the audit committee to oversee the audit and the engagement of the audit firm, audit committees should give thought to how best to make use of the information communicated by the audit firm under the new standard. The new standard means that the audit committee will receive a broader range of information about the audit earlier in the audit process, and the audit committee should be prepared to incorporate this information into its supervision of the company's audit.

In this regard, management, the audit committee and the audit firm may wish to coordinate on how the required information will be communicated. As the PCAOB's release notes, certain of the communications required by the new standard may already be, and may more appropriately be, communicated by management to the audit committee - for example, management may already have a practice of discussing significant or critical accounting policies and practices and critical accounting estimates with the audit committee. The new standard does not require the audit firm to duplicate the communications made by management but does require the audit firm to ensure that the required communications are made in compliance with the standard's requirements. Also, management should coordinate with the audit firm to ensure required communications are made to the audit committee in an effective and efficient manner while permitting the audit firm to ensure that the standard's requirements have been met. Audit firms will likely seek assurance from management that they have the information necessary to fulfill their communications requirements, through additions to management representation letters or other means.

An audit committee may want to consider changing procedures and perhaps even amending its charter to incorporate the new communication requirements into its oversight of the audit process. Possible steps might include the following:

- Audit committees may wish to discuss with audit firms a timeline for communications that will provide the committee with the best opportunity to use the information provided by the audit firm. For example, an audit committee may want to discuss the audit strategy with the audit firm relatively early in the audit process in order to ensure that the committee is comfortable with the planned approach and has an opportunity to raise any concerns at a point where they can be addressed in the course of the audit.
- As discussed above, an audit firm is required to inquire of the audit committee whether it is aware of matters relevant to the audit, including, but not limited to, knowledge of violations or possible violations of law or regulations. Although not required, an audit firm may choose to seek a representation letter from the audit committee addressing such matters. The audit committee should have a process for preparing a response to this inquiry.
- Audit firms are required to communicate certain matters that may trigger difficult or sensitive decisions or actions by the audit committee, such as significant unusual transactions or specific concerns about the audit policies and processes chosen by management. The audit committee may wish to develop a policy for responding to particular categories of communications so that, if auditor communications disclose potential problems, there is a framework in place that will help the committee develop an appropriate response in a timely manner.

- The new standard provides that communications may be oral or written. Audit committees may wish to discuss with audit firms the form communications will take, weighing the relative efficiency and convenience of written communication against the challenges associated with communicating sensitive information in writing.
- The new standard's emphasis on two-way communication and the potential for multiple communications as the audit progresses may increase the importance to the audit committee of a chair that is able to work closely and effectively with the audit firm.

## CONCLUSION

In its release accompanying AS No. 16, the PCAOB said that while under the previously applicable interim standards an audit firm's communications with the audit committee were deemed "incidental" to the audit, the new standard "recognizes the importance of the auditor's communications with the audit committee in today's regulatory and business environment."<sup>11</sup> AS No. 16 provides a guide to what the PCAOB believes audit committees should understand about the audit and the independent audit firm's views of the audit. Audit committees should expect to receive materials from their companies' audit firms outlining the new standard and how audit firms intend to implement the standard, and should be prepared to work with audit firms to develop a process that enhances the committee's role in supervising the audit.

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If you have any questions concerning the material discussed in this client advisory, please contact the following members of our securities practice group:

<b>Bruce Bennett</b>	+1.212.841.1060	<a href="mailto:bbennett@cov.com">bbennett@cov.com</a>
<b>Nora Gibson</b>	+1.415.591.7044	<a href="mailto:ngibson@cov.com">ngibson@cov.com</a>
<b>David Martin (author)</b>	+1.202.662.5128	<a href="mailto:dmartin@cov.com">dmartin@cov.com</a>
<b>Kristian Wiggert</b>	+44.(0)20.7067.2280	<a href="mailto:kwiggert@cov.com">kwiggert@cov.com</a>
<b>Erik Durbin (author)</b>	+1.202.662.5326	<a href="mailto:edurbin@cov.com">edurbin@cov.com</a>

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<sup>11</sup> Adopting Release at 4.