

Heads Up

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Overall, the PCAOB is seeking to improve audit committee communications by expanding upon existing required communications.

PCAOB Reproposes Auditing Standard on Communications With Audit Committees

by Jennifer Burns, Deloitte LLP, and Megan Zietsman, Deloitte & Touche LLP

On December 20, 2011, the PCAOB [reproposed an auditing standard](#)¹ on communications with audit committees that would supersede PCAOB AU Sections 310² and 380.³ The PCAOB expects the repropose standard to be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

The repropose standard is the result of modifications made to the proposal originally issued by the PCAOB on March 29, 2010. The PCAOB revised the original proposal after reviewing feedback provided through comment letters and from a roundtable session held in September 2011 on the original proposal.

The PCAOB's primary objectives in repropose the standard are to provide respondents with the opportunity to comment on the repropose given (1) changes that would align it with requirements in the PCAOB's new risk assessment standards (which became effective after the original proposal), (2) the PCAOB's authority over broker-dealer audits (which also became effective after the original proposal) and the application of the standard to those audits, and (3) other additions and changes to the original proposal.

This *Heads Up* gives an overview of the repropose standard and highlights significant changes from current standards and the original proposal.

Themes and Considerations Regarding the Reproposed Communication Requirements

Overall, the PCAOB is seeking to improve audit committee communications by expanding upon existing required communications, including those related to critical accounting policies, practices, and estimates as well as significant unusual transactions, significant risks, going-concern considerations, and the auditor's evaluation of the quality of the company's financial reporting. The proposal also addresses the importance of the auditor's obtaining information from the audit committee about its knowledge of complaints or concerns expressed about audit or accounting matters. Note that although auditors are already carrying out many of the new or expanded requirements today, they may not necessarily be doing so consistently throughout the profession.

The repropose standard carries forward substantially all of the communication requirements of the current standards and, in certain circumstances, requires auditors to provide additional communications. The table in the [appendix](#) of this *Heads Up* lists the communications required by the repropose standard as well as by other PCAOB standards and rules and identifies those that are new or expanded (relative to current requirements) as a result of the repropose standard.

¹ PCAOB Proposed Auditing Standard *Communications With Audit Committees*.

² PCAOB AU Section 310, "Appointment of the Independent Auditor."

³ PCAOB AU Section 380, "Communication With Audit Committees."

The repropo-
sed
standard removes the
objective and related
communication
requirements with
respect to evaluating
the adequacy of the
two-way
communications
between the auditor
and the audit
committee.

The most significant differences between the original proposal and the repropo-
sed standard are that:

- The repropo-
sed adds requirements “for the auditor to communicate to the audit
committee [about] significant unusual transactions [and] the business rationale
for such transactions.”
- The repropo-
sed deletes the originally proposed requirement that the auditor
evaluate “the adequacy of the two-way communications between the auditor
and the audit committee.”

These changes are discussed in more detail below.

Opportunity for Public Comment

**We encourage audit committees to study the repropo-
sed and to submit
comments to the PCAOB. Audit committees should carefully consider whether
and, if so, how the requirements in the proposal will improve communication
and, ultimately, audit committee performance.** For instance, audit committees may
wish to consider:

- Whether the repropo-
sed will result in required communications that are useful to
the audit committee as well as what should be added, deleted, or made optional
in the repropo-
sed standard.
- Whether there are aspects of the repropo-
sed standard that will improve or will
hinder communications.

Comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W.,
Washington, D.C. 20006-2803. Comments also may be submitted via [e-mail](#) or the
PCAOB’s [Web site](#). All comments should refer to PCAOB Rulemaking Docket Matter No.
30 in the subject or reference line and should be received by the PCAOB no later than
5:00 p.m. (EST) on February 29, 2012.

Overview of the Repropo- sed Standard

The repropo-
sed standard states that the objectives of the auditor are to:

- a. Communicate to the audit committee the responsibilities of the auditor in relation to
the audit and establish an understanding of the terms of the audit engagement with
the audit committee;
- b. Obtain information from the audit committee relevant to the audit;
- c. Communicate to the audit committee an overview of the overall audit strategy and
timing of the audit; and
- d. Provide the audit committee with timely observations arising from the audit that are
significant to the financial reporting process.

The repropo-
sed standard outlines requirements (discussed below) that are intended
to fulfill the above objectives, many of which are present in the current standards and
unchanged from the original proposal.

Editor’s Note: As discussed previously, the repropo-
sed standard removes the
objective and related communication requirements with respect to evaluating the
adequacy of the two-way communications between the auditor and the audit
committee, both of which were included in the original proposal. Nevertheless, as the
release accompanying the repropo-
sed explains, the auditor remains responsible for
assessing the audit committee’s effectiveness under PCAOB Auditing Standards 5⁴
and 12.⁵

⁴ PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of
Financial Statements*.

⁵ PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Under Auditing Standard 12, the
auditor obtains an understanding of the control environment, including whether the board or audit committee understands
and exercises oversight responsibility over financial reporting and internal control. In addition, under Auditing Standard 5
and paragraph 5 of PCAOB AU Section 325, *Communications About Control Deficiencies in an Audit of Financial Statements*,
if the auditor becomes aware or concludes that the audit committee’s oversight of the external financial reporting and
internal control over financial reporting is ineffective, the auditor is required to communicate that information to the audit
committee.

Appointment and Retention

Significant Issues Discussed With Management

The repropose standard reiterates the existing requirement of auditors to communicate to the audit committee any significant issues discussed with management in connection with the auditor's initial appointment or retention. The release that accompanies the repropose standard adds that the scope of the discussion should relate to only the most important matters that might influence the appointment or retention of the auditor.

Editor's Note: This provision of the repropose standard is substantively unchanged from the initial proposal.

Establish an Understanding of the Terms of the Audit

Under the reproposal, the auditor should establish annually an understanding of the terms of the engagement with the appropriate party or parties (as identified by the company). The auditor is required to achieve this by recording such understanding in a written engagement letter and providing such engagement letter to the appropriate party or parties (as identified by the company) each year. Among other things, the letter should describe the objective of an audit, the auditor's responsibilities, and the responsibilities of management. If the appropriate party is someone other than the audit committee or is its chair, the auditor should determine that the audit committee acknowledges and agrees to the terms of the engagement. This acknowledgement is not required to be in writing.

Editor's Note: This provision of the repropose standard is substantively unchanged from the initial proposal; however, it now specifically requires the auditor to establish annually a mutual understanding with the appropriate party or parties and, if the appropriate party is not the audit committee, to determine that the audit committee acknowledges and agrees to the terms of the engagement. Current auditing standards were written before the Sarbanes-Oxley Act of 2002; therefore, they do not specifically require that understanding be reached with the audit committee, nor do they require documentation of the terms of the engagement in an annual engagement letter. However, it is common practice for auditors to use written engagement letters and to execute such letters with audit committees.

Obtaining Information and Communicating the Audit Strategy

Obtaining Information Related to the Audit

The reproposal requires the auditor to ask 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 laws or regulations and complaints or concerns raised regarding financial reporting matters (e.g., tips or complaints received through the audit committee's internal whistleblower program). This aspect of the repropose standard complements other requirements in Auditing Standard 12 to inquire of the audit committee regarding risks of material misstatement, including fraud risk.

Editor's Note: The language in this provision of the repropose standard regarding inquiring of the audit committee about "knowledge of violations or possible violations of laws or regulations" was not in the original proposal. The PCAOB, in its release, explains that this language was expanded because other matters the audit committee is aware of, including possible violations of laws, may be relevant to financial reporting and controls over financial reporting. Although these types of discussions typically take place currently, they are not specifically required under existing standards.

The repropose standard reiterates the existing requirement of auditors to communicate to the audit committee any significant issues discussed with management in connection with the auditor's initial appointment or retention.

The PCAOB's
reproposed standard
differentiates
between *significant*
accounting policies
and practices and
critical accounting
policies and
practices.

Overview of the Audit Strategy and Timing of the Audit

Under the reproposal, the auditor should give the audit committee an overview of the overall audit strategy, including a discussion of the significant risks and the timing of the audit. In addition, the reproposal requires the auditor to timely communicate significant audit strategy changes or changes to the significant risks. The communication of the audit strategy should include (1) the nature and extent of specialized skill or knowledge needed in the performance of the planned procedures and evaluation of the results; (2) the consideration and planned use by the auditor of the work of internal auditors and similar persons; (3) the names, roles, responsibilities, locations, and scope of work of the firms participating in the audit (those in and out of the network to which the principal auditor belongs); and (4) the basis for the auditor's determination that he or she can serve as the principal auditor if significant parts of the audit will be performed by other auditors.

Editor's Note: This provision of the reproposed standard is substantively unchanged from the initial proposal. Although these types of discussions typically take place currently, they are not specifically required under existing standards.

Results of the Audit

Accounting Policies, Practices, and Estimates

The reproposed standard substantively carries forward existing auditor communication requirements regarding:

- The "initial selection of, and changes in significant accounting policies, or the application of such policies."
- "The methods management used to account for significant unusual transactions."
- "The effect of significant accounting policies on financial statements or disclosures."

Critical Accounting Policies, Practices, and Estimates

The PCAOB's reproposed standard differentiates between *significant* accounting policies and practices and *critical* accounting policies and practices. The term "critical accounting policies and practices" is defined by the PCAOB (and aligns with the SEC's definition) as "the company's accounting policies and practices that are both most important to the portrayal of the company's financial position 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." Significant accounting policies and practices involve a broader range of matters over time, whereas critical accounting policies and practices, as discussed in the PCAOB's release, are tailored to specific events in the current year. Thus, critical accounting policies and practices would be a subset of significant accounting policies and practices.

Further, the reproposed standard aligns the definition of "critical accounting estimate" with that used by the SEC; namely, an "estimate where (a) the nature of the estimate is 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 (b) the impact of the estimate on financial condition or operating performance is material."

With respect to critical accounting policies and practices, the reproposed standard includes requirements that are consistent with those in Regulation S-X, Rule 2-07,⁶ stating that the auditor should report (1) all critical accounting policies directly to the audit committee, (2) all alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items discussed with management, and (3) other material written communications between the auditor and management.

⁶ Regulation S-X, Rule 2-07, "Communication With Audit Committees."

The repropoed standard specifically requires the auditor to communicate the results of the evaluation of the qualitative aspects of significant accounting policies and practices.

The repropoed standard also carries forward the existing communication requirements regarding:

- “[T]he process used by management to develop critical accounting estimates.”
- The “significant assumptions used in [such] estimates that have a high degree of subjectivity” and any changes in the process or assumptions.
- “The basis for the auditor’s conclusions regarding the reasonableness of the critical accounting estimates.”

The repropoal outlines new communication requirements with respect to the following:

- The “reasons certain policies and practices are considered critical, and . . . how current and anticipated future events might affect the determination of [what is] considered critical.”
- Any “significant changes management made to the processes used to develop critical accounting estimates, . . . management’s reasons for the changes, and the effects of the changes on the financial statements.”

With respect to critical accounting estimates, the repropoed standard also clarifies that if management communicates to the audit committee about the required matters, the auditor does not need to communicate the same matters at the same level of detail as long as the auditor:

- “[P]articipated in management’s discussion with the audit committee.”
- “[A]ffirmatively confirmed to the audit committee that management has adequately communicated [the required] matters.”
- “[I]dentified for the audit committee those accounting policies and practices that the auditor considers critical.”

The repropoed standard removes communication requirements in the original propoal related to the following:

- “How management subsequently monitors . . . estimates.”
- “[I]nformation that supports or challenges [significant] changes” in critical accounting estimates.
- “When critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and how various selections within the range would affect the company’s financial statements.”

The Auditor’s Evaluation of the Quality of Financial Reporting

The repropoed standard specifically requires the auditor to communicate the results of the evaluation of the qualitative aspects of significant accounting policies and practices, including situations in which the auditor identifies bias in management judgments about the amounts and disclosures in the financial statements. In addition, the auditor would be required under the repropoed standard to communicate his or her evaluation of the presentation of the financial statements, including specifically the form, arrangement, content, terminology, amount of detail given, and bases of amounts set forth.

As discussed previously, the repropoed standard carries forward communication requirements (contained in Regulation S-X, Rule 2-07) regarding:

- “Alternative accounting treatments . . . for policies and practices related to material items that have been discussed with management.”
- “Material written communications . . . between the auditor and management.”

The reproposal adds a requirement for the auditor to communicate to the audit committee significant unusual transactions that the auditor is aware of.

In addition, the reproposed standard contains new communication requirements related to:

- “[D]ifficult or contentious matters for which the auditor consulted outside the engagement team [and] that the auditor reasonably determined are relevant to the audit committee’s oversight.” (Note that the original proposal contained an exception regarding consultations with the engagement quality reviewer; this exception has not been retained in the reproposed standard.)
- “Situations in which . . . the auditor identified a concern regarding management’s anticipated application of [significant new] accounting pronouncements.” (Note that this aspect of the reproposal has been narrowed from the original proposal, which would have required the auditor to communicate with the audit committee about the anticipated application by management of all new accounting and regulatory pronouncements.)
- The auditor’s “assessment of management’s disclosures related to critical accounting policies and practices, along with any significant modifications to the disclosures . . . proposed by the auditor that management did not make.”
- “The basis for the auditor’s conclusions regarding the reasonableness of the critical accounting [policies].”

Editor’s Note: We believe that some of the above aspects of the reproposed standard are similar to and appear to replace current communication requirements to the audit committee regarding the auditor’s judgments about the quality, and not just the acceptability, of the company’s accounting principles.

Significant Unusual Transactions

Current standards require the auditor to communicate with the audit committee about the methods used to account for significant unusual transactions. The reproposal adds a requirement for the auditor to communicate to the audit committee significant unusual transactions that the auditor is aware of, including the timing, size, nature, and business rationale for such transactions.

Editor’s Note: This provision of the reproposed standard was not in the original proposal. As noted above, AU Section 380 contains a provision related to the auditor’s determination that the audit committee is informed about the methods used to account for significant unusual transactions. Therefore, the new aspect of this provision relates to the requirement to communicate about additional elements of the significant unusual transactions (including the auditor’s understanding of the business rationale for them), not just the methods to account for them.

Management Consultations With Other Accountants

The reproposal carries forward the current requirement to communicate management’s consultations with other accountants about auditing or accounting matters, including the auditor’s views about such matters; however, unlike the current standard, the reproposal states that such communications should only relate to those matters about which the auditor has identified a concern.

Editor’s Note: The list of items that must be communicated is narrower under the reproposed standard than it was under the original proposal. Under the reproposal, such items are limited to consultations with outside accountants that relate to significant matters about which the auditor has identified a concern.

Going Concern

Although auditors typically communicate going-concern matters to the audit committee when applicable, they are not required to do so under current PCAOB standards. The reproposed standard requires that the auditor communicate (1) the conditions and events the auditor identified that indicate there could be substantial doubt about the

company's ability to continue as a going concern for a reasonable period and (2) the information that mitigated the auditor's doubt (if such doubt was indeed mitigated). If the auditor concludes that substantial doubt was not mitigated, the auditor is required to communicate any effects on the financial statements, including the disclosures and on the auditor's report.

Editor's Note: Unlike the original proposal, the repropoed standard does not require the auditor (if the auditor has concluded that there is substantial doubt about the ability to continue as a going concern for a foreseeable period) to communicate his or her assessment of management's plans to overcome the conditions and events that gave rise to the substantial doubt and management's ability to implement the plans.

The FASB has on its agenda a related project on disclosures about risks and uncertainties and the liquidation basis of accounting (formerly going concern). See the FASB's [project update page](#) for information about this project.

Uncorrected and Corrected Misstatements

The repropoed standard reiterates the existing requirements to communicate corrected and uncorrected misstatements. It also emphasizes that auditors should include misstatements related to disclosures when communicating misstatements. In addition, it requires the auditor to:

- "[D]iscuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements [are] immaterial, including the qualitative factors considered."
- "[C]ommunicate that uncorrected misstatements or matters underlying those uncorrected misstatements could cause future period financial statements to be materially misstated."

Editor's Note: This provision of the repropoed standard and the discussion in the accompanying release clarify that such misstatements refer only to those identified in the audit process.

Other Matters

Under the repropoed standard, the auditor should communicate matters that have arisen during the audit that are significant to the oversight of the financial reporting process. Such matters include situations in which the auditor is aware of concerns having been raised about auditing or accounting and the results of the auditor's procedures regarding such concerns.

Editor's Note: This provision of the repropoed standard is substantively unchanged from the initial proposal.

Other Communication Requirements

The repropoed standard includes communication requirements, largely taken from the existing standards, that address the auditor's responsibility in connection with information in documents containing audited financial statements, disagreements with management, and difficulties encountered in performing the audit.

The repropoed standard also requires the auditor to inform the audit committee if the auditor expects to modify an opinion or add an explanatory paragraph in the auditor's report and to explain the reasons why.

Editor's Note: These provisions of the repropoed standard are substantively unchanged from the initial proposal.

Under the repropoed standard, the auditor should communicate matters that have arisen during the audit that are significant to the oversight of the financial reporting process.

The proposed standard would apply to all audits of broker-dealers.

Form and Documentation of the Communications

The repropoed standard allows the auditor to communicate to the audit committee either orally or in writing. In both cases, the auditor is specifically required to document such communications in the workpapers and to indicate whether they were oral or written. Under the existing standard, any written communication is restricted to the use of the audit committee, board of directors, or management. The repropoed standard does not contain this requirement, although, in accordance with the PCAOB's standards,⁷ auditors may continue to restrict the use of written communications by specifying the intended users.

Editor's Note: This provision of the repropoed standard is substantively unchanged from the initial proposal.

Timing of Communications

Currently, communications with audit committees are not specifically required to occur before the issuance of the auditor's report, although in practice they typically take place before it is issued and before the related filing of the annual financial statements. The PCAOB has explained its view that communications are considered an integral part of the audit and not incidental to the process. The repropoed standard (like the original proposal), therefore, specifically requires the communications to be completed with the full audit committee before issuance of the auditor's report, and, because the significance of specific matters may change from year to year, it requires annual communication of recurring matters.

Editor's Note: This provision of the repropoed standard is substantively unchanged from the initial proposal.

Application to Audits of Broker-Dealers

The repropoed standard would apply to all audits of broker-dealers. The Dodd-Frank Wall Street Reform and Consumer Protection Act gave the PCAOB authority to oversee the audits of broker-dealers registered with the SEC. The SEC has stated in interpretive guidance that for transitional purposes, audits of broker-dealers should continue to be conducted in accordance with the standards of the AICPA while it reconsiders its rules related to such audits.

Currently, although AICPA standards on audit committee communications apply to audits of broker-dealers, the PCAOB's interim standard on audit committee communications, AU Section 380, does not apply to audits of broker-dealers that do not have an audit committee.

As a result, if the SEC updates its rules such that PCAOB standards apply to audits of broker-dealers before the approval of the repropoed standard, there could be a timing gap in PCAOB requirements for audit committee communications in connection with audits of broker-dealers. Accordingly, the PCAOB has included a transitional amendment in the repropoed standard that would make the communication requirements in AU Section 380 applicable to audits of broker-dealers (once the SEC approves rules that make PCAOB standards applicable to audits of broker-dealers) until the repropoed standard is finalized and approved.

³ See paragraphs .07 –.11 of PCAOB AU Section 532, *Restricting the Use of an Auditor's Report*.

Appendix

The table below (1) lists the communications to audit committees required by (a) the repropoed standard and (b) other PCAOB standards and rules and (2) indicates whether communications required by the repropoed standard are new or expand on current requirements.

Communications Required by the Repropoed Standard	New or Expanded Requirement
Significant issues discussed with management before the auditor's appointment or retention.	
Mutual understanding of the terms of the audit.	Expanded
Overview of the audit strategy and timing of the audit.	New
Accounting policies, practices, and estimates, including critical accounting policies, practices, and estimates.	Expanded
Auditor's evaluation of the quality of the company's financial reporting.	Expanded
Timing, size, nature, and business rationale for significant unusual transactions.	Expanded
Other information in documents containing audited financial statements.	
Management consultations with other accountants.	
Going concern.	New
Uncorrected and corrected misstatements.	
Departure from the standard auditor's report.	New
Disagreements with management.	
Difficulties encountered in performing the audit.	
Other matters.	New
Communications Required by Other PCAOB Standards or Rules	
Material weaknesses and significant deficiencies in internal control.	
Representations of management.	
Fraud and illegal acts.	
Communications in connection with interim reviews.	
Preapproval of services.	
Independence matters.	

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