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Audit & Assurance Update
December 21, 2017

Contents

A Summary of the November 29–30 Meeting of the PCAOB's Standing Advisory Group

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Introduction

At the November 29–30, 2017, PCAOB Standing Advisory Group (SAG) meeting, the PCAOB provided an update on recent developments, including its standard setting and related research activities. In addition, the PCAOB sought perspectives from SAG members on audit quality indicators, professional skepticism, and implementation of new accounting standards. FASB and IAASB board members also provided updates on their recent standard setting activities.

This *Audit & Assurance* Update summarizes the highlights of the meeting.

Recent PCAOB Developments

Chairman James Doty[1] summarized recent PCAOB activities, including the following:

[1] Subsequent to the SAG meeting, on December 12, 2017, the SEC announced the appointment of William D. Duhnke III as Chairman of the PCAOB and J. Robert Brown, Kathleen M. Hamm, James G. Kaiser, and Duane M. DesParte as Board members of the PCAOB. The transition to the new Board will occur beginning in January 2018.

- *2018 Budget and 2017-2021 Strategic Plan* — On November 16, 2017, the Board approved its 2018 fiscal-year budget of approximately $259.9 million and its 2017-2021 strategic plan. The 2018 budget is $8.6 million (subject to SEC approval), or 3.2 percent, less than the 2017 budget of $268.5 million. Chairman Doty stated that the 2018 budget included additional funding for information technology and will allow the PCAOB to conduct rigorous inspections in both the United States and abroad.
- *Standard-setting* — Chairman Doty discussed the PCAOB's adoption of the new auditor reporting standard[2] (approved by the SEC on October 23, 2017) and implementation of the transparency rule.[3] See further details below.
- *Economic analysis* — Chairman Doty stated that the PCAOB remains committed to evidence-based oversight and policy making in order to use regulatory tools and resources efficiently. In addition, Chairman Doty explained that the PCAOB has developed an approach to assess the economic impact of the new standards through post-implementation review.
- *Inspections* — Chairman Doty discussed the PCAOB's recently issued Staff Inspection Brief that discusses 2017 focus areas for inspections, including assessing and responding to risks of material misstatement, internal control over financial reporting (ICFR), and evaluating accounting estimates, including fair value measurements. He also mentioned that new to this year's inspection cycle was the incorporation of random selections of engagements for inspection. The PCAOB is hopeful that incorporating randomization into its risk-based selection process will enhance the deterrent effect of the inspections and provide further information on the state of audit quality.

Chairman Doty further discussed the Board's continued efforts to develop broker-dealer auditor oversight, its enforcement program, strengthening inspections abroad, and other recent accomplishments of the Board, including reaching a bilateral cooperative agreement with Ireland that will allow the PCAOB to conduct joint inspections and coordinate other oversight, as well as continued efforts to reach similar agreements in remaining European countries and in China.

Standard-Setting Activities

Standards–Setting Update

Chief Auditor and Director of Professional Standards Martin Baumann provided an update on the PCAOB's standard-setting projects, including the following:

The Auditor's Reporting Model

Mr. Baumann discussed the key changes included in PCAOB Auditing Standard (AS) 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. While the standard retains its "pass/fail" approach, it also includes several modifications to the auditor's report. The most significant change is a new required section communicating critical audit matters (CAMs) arising from the audit of the current period's financial statements.

[2] PCAOB Auditing Standard (AS) 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. See Deloitte's June 20, 2017, *Heads Up* newsletter for more information on the PCAOB's changes to the auditor's report.

[3] PCAOB rule *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*.

Definition of a Critical Audit Mattert

CAMs are matters arising from the audit of the financial statements that were communicated or required to be communicated to the audit committee and that:

- Relate to accounts or disclosures that are material to the financial statements and
- Involved especially challenging, subjective, or complex auditor judgment.

Other changes to the auditor's report include:

- Standardized ordering and inclusion of section headers, with the opinion section appearing first.
- Enhanced descriptions of the auditor's role and responsibilities, including a statement regarding independence requirements.
- Disclosure of auditor tenure — the year in which the auditor began serving consecutively as the company's auditor.

The effective date will be phased in as follows:

All changes except for communication of CAMs:

- Audits of fiscal years ending on or after December 15, 2017.

Communication of CAMs:

- Audits of large accelerated filers: Fiscal years ending on or after June 30, 2019.
- Audits of all other companies: Fiscal years ending on or after December 15, 2020.

Auditors may elect to comply with the new requirements before the effective date.

Refer to Deloitte's June 20, 2017, Heads Up *newsletter for more information on the PCAOB's changes to the auditor's report.*

The PCAOB believes that the determination and communication of CAMs should be addressed in the context of a particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks. Mr. Baumann stated that CAMs should provide investors with a unique perspective on the challenging audit areas, including areas such as significant management estimates and judgments, unusual transactions, and other areas related to significant risk of material misstatement in the financial statements. In his opinion, communicating CAMs should improve the knowledge investors will obtain from the financial statements. Mr. Baumann explained that the phased effective dates for CAMs were developed to provide auditors, companies, and audit committees more time to prepare for implementation.

Most SAG members expressed support for the new standard, noting that investors are experiencing benefits of enhanced auditor's reporting that is already taking place outside the United States.[4] One SAG member cautioned that if the standard is not embraced and implemented as intended, CAMs might become boilerplate. Another SAG member suggested that companies work with their auditors to undertake a "trial run" of CAMs prior to the effective date, and that doing so will give companies an opportunity to expand their disclosures, if needed, so that there are no surprises to investors when auditors begin reporting CAMs. Marc Panucci, SEC Deputy Chief Accountant in the Office of the Chief

[4] In January 2015, new and revised auditor reporting standards were issued by the IAASB and are effective for audits of financial statements for periods ending on or after December 15, 2016. In addition, in June 2013, the Financial Reporting Council (FRC) in the United Kingdom adopted revisions to its standards to enhance the transparency of the auditor's report and communication to investors. To comply with the IAASB's revised auditor reporting standards and the EU's requirements, in April 2016, the FRC adopted a final rule, which applies to all listed entities, updating its 2013 auditor reporting requirements.

Accountant and observer to the SAG, noted that the effective date allows for adequate planning and preparation to take place prior to the effective date of CAMs. Mr. Baumann concluded that if the companies and auditors have any questions as they are implementing the new reporting requirements, the PCAOB is prepared to answer questions, issue additional guidance,[5] and will be closely monitoring the implementation of the new standard.

Disclosure of the Engagement Partner and Other Audit Firms Participating in an Audit

Mr. Baumann discussed the requirements for registered public accounting firms to provide engagement partner names (for audit reports issued on or after January 31, 2017) and information about certain other accounting firms participating in the audit (for audit reports issued on or after June 30, 2017).[6] He stated that over 12,500 Form APs providing this information have been filed with the PCAOB by nearly 450 audit firms and more than 180 Form APs filed include information about other accounting firms that participated in the audit. He noted that the requirement regarding participation by other firms is providing meaningful data and will be useful over time to better understand who is involved in performing audits.

Staff Audit Practice Alert No. 15, Matters Related to Auditing Revenue from Contracts with Customers

On October 5, 2017, the PCAOB published an alert in order to assist auditors in applying PCAOB standards when auditing companies' implementation of the new revenue standard.[7] This alert highlights PCAOB requirements and other considerations for auditors, including:

- Transition disclosures and transition adjustments.
- Internal control over financial reporting.
- Fraud risks.
- Revenue recognition.
- Disclosures.

Mr. Baumann stated that the alert was informed by monitoring activities and SAG discussions.

Going Concern

The PCAOB continues to evaluate whether revisions are needed to the PCAOB's existing standard[8] that addresses the auditor's consideration of an entity's ability to continue as a going concern in light of changes in the accounting requirements.[9] The staff has been closely monitoring the implementation of the accounting standard and reviewing management's disclosures when auditors issue an auditor's report that contains an explanatory paragraph because of substantial doubt about the entity's ability to continue as a going concern. Mr. Baumann stated that, for now, the PCAOB has chosen not to adopt the FASB's definition of "substantial doubt" but is continuing its monitoring and outreach activities.

[5] Subsequent to the SAG meeting, on December 4, 2017, the PCAOB published Staff Guidance on Implementing Changes to Auditor's Report that describes changes to the auditor's report that became effective for audits for fiscal years ending on or after December 15, 2017. The guidance also provides a high-level overview of the requirements regarding CAMs.

[6] See Deloitte's January 11, 2016, *Audit & Assurance Update* newsletter for more information on the PCAOB's rule regarding the transparency of audits. This information is provided to the PCAOB through its Form AP and is publically available through *AuditorSearch* (a searchable database) on the PCAOB's website.

[7] FASB Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*.

[8] Auditing Standard (AS) 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, establishes requirements for the auditor's evaluation of a company's ability to continue as a going concern. Among other things, AS 2415 requires the auditor to modify the auditor's report by including an explanatory paragraph when substantial doubt exists about the company's ability to continue as a going concern. Also, see section 10A(a)(3) of the Securities Exchange Act of 1934, which requires that audits of issuers include "an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year."

[9] In accordance with ASU 2014-15, which became effective for annual periods ending after December 15, 2016, management is required to (1) evaluate the company's ability to continue as a going concern and (2) provide certain related disclosures. See further discussion in Deloitte's June 12, 2017, *Audit & Assurance Update* newsletter.

Auditing Accounting Estimates, Including Fair Value Measurements

On June 1, 2017, the PCAOB proposed changes to its standards related to auditing accounting estimates,[10] including fair value measurements. The proposal is intended to update and strengthen the requirements for auditing accounting estimates. The PCAOB staff discussed the comment letters received on the proposal,[11] noting that, overall, commenters were supportive of developing a single principles-based standard while retaining the existing approaches to auditing accounting estimates. Commenters offered certain suggestions and refinements related to some specific requirements in the proposal, including:

- Avoid requirements that are overly prescriptive and diminish the auditor's application of risk-based judgment.
- Clarify the factors relevant to evaluating estimation methods and identifying significant assumptions used by the company when testing the company's process.
- Provide additional guidance to auditors regarding establishing an appropriate range of estimates.

The PCAOB is evaluating the comments received and expects to take action in 2018.

Auditor's Use of the Work of Specialists

Also on June 1, 2017, the PCAOB proposed changes to its standards related to the auditor's use of the work of specialists. The proposal is intended to (1) strengthen requirements for the auditor to evaluate the work of a company's specialist, and (2) apply a risk-based approach to supervising and evaluating the work of both auditor-employed and auditor-engaged specialists.[12] The PCAOB has observed that, in many cases, specialists are used to either develop or assist in evaluating various accounting estimates. Therefore, stakeholders urged, and the PCAOB agreed, to coordinate these two projects and presented the proposed standards for comment at the same time.

The PCAOB staff discussed the comment letters received,[13] noting that, overall, commenters were supportive of the PCAOB's proposal to separate the requirements for using the work of a company's specialist and an auditor's specialist and to align the applicable requirements with the PCAOB's risk assessment standards. Commenters offered certain suggestions related to some of the specific requirements in the proposal, including:

- Clarify what procedures an auditor would be expected to perform to assess the specialist's relationship to the company and the relationship of the entity that employs the specialist to the company.
- Consider limitations in the auditor's ability to evaluate work of a company's specialist when the specialist uses propriety methodologies to which the auditor lacks access and/or when the auditor may not have the expertise to perform such evaluation.
- Clarify the requirement for the auditor to evaluate whether the data was "appropriately used" by the specialists.

The PCAOB is evaluating the comments received and expects to take action in 2018.

Supervision of Audits Involving Other Auditors

On April 12, 2016, the PCAOB proposed amendments to its standards to strengthen requirements that apply to auditors that are not part of the accounting firm that issues the

[10] See Deloitte's June 12, 2017, *Audit & Assurance Update* newsletter for the details of the auditing accounting estimates and use of other auditors proposals.
[11] See the PCAOB website for comment letters received on the auditing accounting estimates proposal.
[12] See Deloitte's June 12, 2017, *Audit & Assurance Update* newsletter for the details of the auditing accounting estimates and use of other auditors proposals.
[13] See the PCAOB website for comment letters received on the use of specialists proposal.

audit report ("other auditors"), and a new standard for situations in which the auditor divides responsibility for the audit with another accounting firm. The amendments are designed to improve the quality of audits involving other auditors and to align with the PCAOB's risk-based standards. The PCAOB received comments seeking clarifications to some provisions and changes to others. The staff analyzed comments received and on September 26, 2017, issued a supplemental request for comment (SRC) with targeted revisions related to certain areas of the proposal.[14]

Comments[15] on the SRC were due November 15, 2017. The PCAOB staff discussed the comment letters received, noting that, overall, commenters supported enhancing and promoting consistency in the auditor's supervisory responsibilities of other auditors using a risk-based approach. However, many raised concerns about the detailed requirements and provided related recommendations, including:

- Provide guidance on:
  - How the lead auditor would "determine an other auditor's compliance with independence and ethics" when the other auditor is not a member of the same network.
  - How much additional understanding would be necessary when the other auditor is part of the same network and therefore is expected to comply with network-level independence and ethics policies and guidance.
  - How the lead auditor would comply with the requirements to "hold discussions with and obtain information from the [...] referred-to auditors [...] to identify and assess the risk of misstatement..." if direct interaction with the other auditor is not possible.
- Revise the requirement that the lead auditor inquire about the other auditor's policies and procedures related to the assignment of individuals to audits conducted under PCAOB standards and the training of such individuals.
- Clarify that other auditors can function as supervisory team members.

The PCAOB is evaluating the comments received and expects to take action in 2018.

Research Projects Update

Mr. Baumann and PCAOB staff discussed the current projects on the Board's research agenda, as follows:

Changes in the Use of Data and Technology in the Conduct of Audits

The staff is exploring whether there is a need for guidance or changes to the PCAOB standards in light of the increased use of new technologies in the conduct of audits. Mr. Baumann discussed how high-powered technology, sophisticated data analytic techniques, and developments such as the use of artificial intelligence have the potential to transform how audits are performed. He stated that it is imperative that the PCAOB standards permit or promote such advances as appropriate as well as address potential new audit risks that these changes in data and technology might bring. The staff is considering academic research, activities of others (including other auditing standard setters and related working groups, such as the IAASB's Data Analytics Working Group), and observations of the SAG at the May 2017 meeting.[16] In addition, the PCAOB is performing outreach with stakeholders, software developers, investors, and meeting with large and small audit firms to gain further insights on how technology is being used in the audit.

[14] See Deloitte's September 27, 2017 publication for details of the SRC.

[15] See the PCAOB website for comment letters received on both the proposal and supplemental request for comment related to supervision of other auditors.

[16] See Deloitte's June 22, 2017, *Audit & Assurance Update* newsletter for SAG observations related to the use of data and technology.

To further benefit this research and to advance the project more rapidly, the Board has approved the establishment of a data and technology SAG task force to support the work of the PCAOB staff and provide additional insight about the use of, and issues related to, data analytics. Potential focus topics of the task force include:

- Journal entry selection.
- Auditing 100% and related analysis and approach to outliers and non-outliers.
- Use of data analytics as an alternative to sampling.
- Data analytics and significant risks.
- Blockchain.
- Artificial intelligence.

Members of management, audit professionals, investors, and other stakeholders will be encouraged to participate.

SAG members made several suggestions, including:

- Include on the task force members from start-ups, tech organizations, and smaller companies, as such organizations are on the cutting edge of innovations and will provide valuable input.
- Develop common terminology.
- Bifurcate some of the topics into smaller task forces — specifically blockchain and artificial intelligence due to their uniqueness and complexity.

In addition, SAG members and PCAOB staff discussed certain challenges and questions related to advances in technology in the conduct of an audit, particularly with respect to blockchain (including expertise, internal controls, and impacts on the performance of audits as the result of blockchain technology).

What is blockchain technology?

Blockchain is an open digital ledger in which transactions made in bitcoin or another cryptocurrency are recorded without any trusted central authority. The protocol for blockchain allows multiple parties that do not know or trust each other to maintain consensus as to the state of and changes made to a shared database. Bitcoin has leveraged this technology to enable payment transactions between strangers without need for a third-party financial intermediary (i.e., a bank). The range of potential applications is broad and extends to almost every industry, sparking wide interest and investment in blockchain technology over the past several years. For a detailed discussion of the technology, see *Beyond bitcoin: Blockchain is coming to disrupt your industry*.

In closing, SAG members stressed the importance of collaboration among regulators, academics, firms, and issuers to address common issues regarding the use of data and technology in the audit. They also expressed the view that the PCAOB needs to continue its outreach and, through its inspection activities, look for and share best practices. It was further noted that the AICPA will issue nonauthoritative guidance this year on using data analytics.[17]

[17] Subsequent to the SAG meeting, the AICPA issued its *Audit Data Analytics Guide*.

Auditor's Role Regarding Other Information and Company Performance Measures, Including Non-GAAP Measures

The PCAOB is considering whether auditors' responsibilities for other information included in annual reports should be expanded and whether auditors should have greater involvement and responsibility to improve the reliability of other information outside the financial statements, including key performance indicators (KPIs) and non-GAAP financial measures (NGFM).[18]

Jennifer Rand, Deputy Chief Auditor and Deputy Director of Professional Standards, shared the recommendations presented by the working group of PCAOB Investor Advisory Group (IAG) at its October 2017 meeting regarding NGFMs and KPIs, which included:

- Preferred path — FASB defines relevant NGFMs and industry-specific KPIs that would replace NGFMs and that would be included in the audited financial statements.
- Alternative path — Standard-setters and regulators develop requirements for disclosure and reconciliation that would be audited; NGFMs and KPIs are defined by management, with input from industry representatives, and are disclosed for at least three years.
- Interim path — SEC updated Regulation G[19] to require disclosure of how issuers define NGFMs and audits of NGFMs based on each issuer's definition of NGFMs.

SAG members again[20] discussed whether the auditor's role and responsibilities should change in relation to information outside the financial statements. Some SAG members suggested that more can and should be done by regulators and standard-setters to drive greater consistency, comparability, and reliability of KPIs and NGFMs. In closing, several SAG members encouraged the PCAOB to continue to monitor this area and work with the SEC, FASB, and other regulators to coordinate the consideration of any potential actions.

Auditor's Consideration of Noncompliance with Laws and Regulations (NOCLAR)

Ms. Rand gave an overview of the auditor's current responsibilities with respect to NOCLAR[21] and discussed the differences in the auditor's responsibilities for detecting, investigating, and reporting of illegal acts when an act relates to misstatements that have a direct and material effect on financial statements and all other illegal acts. She stated that the staff is considering and researching:

- Whether there is a need for improvements to AS 2405, *Illegal Acts by Clients*, to provide better direction to auditors regarding their role and behavior as well as the impact on incentives and disincentives for auditors to detect, investigate, and report illegal acts.

[18] Performance measures included in a company's annual report are considered "other information" and are subject to PCAOB standards that require auditors to read and consider the other information in documents containing audited financial statements. However, under current PCAOB standards, auditors do not have a responsibility to perform procedures related to information presented outside of the documents that contain audited financial statements. See AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

[19] 17 CFR Part 244 Regulation G requires public companies that disclose or release non-GAAP financial measures to include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.

[20] See Deloitte's June 22, 2017, and June 22, 2016, *Audit & Assurance Update* newsletters which highlight the SAG's discussions about company's performance measures and the role of the auditor.

[21] PCAOB AS 2405, *Illegal Acts by Clients*, establishes requirements regarding the auditor's considerations of possible illegal acts by a client in an audit of financial statements. Section 10A of Securities and Exchange Act of 1934 requires each audit to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on determination on financial statements amounts.

- The differences between PCAOB requirements and those of other standard-setters.[22]
- Investors' understanding about auditor's current responsibilities — specifically, whether there is a demand to change the existing responsibilities — and the impact on investors and capital markets.
- Existing responsibilities of management and the audit committees, including whistleblower practices and adverse incentives caused by government or regulatory intervention.
- Potential costs and benefits of greater auditor involvement.

Ms. Rand shared the recommendations presented by the working group of PCAOB IAG at its October 2017 meeting, including the following:

- Increase the auditor's responsibility for detecting illegal acts that could have a material effect on financial statements.
- Require auditors to assess the risk of an illegal act as part of the audit planning process.
- Make requirements related to auditor's understanding of the company's whistleblower programs more robust.
- Expand management representations about illegal acts or possible illegal acts.

Some SAG members agreed with the IAG recommendation that auditors should be aware of whistleblower activity at the company and expand their audit procedures if they become aware of matters that relate to the financial statements. The discussion concluded that further research is needed before any standard-setting action should take place.

Editor's Note

While not discussed during the SAG meeting due to time constraints, the PCAOB's research agenda also includes *Improvements to quality-control (QC) standards, including assignment and documentation of audit firm supervisory responsibilities* — QC topics currently being considered by the PCAOB include audit firm governance, leadership, and organization; root cause analysis and remediation of quality control deficiencies; using firm risk assessment to proactively address potential risks to the audit firm's quality control; and quality control with respect to other participants in the audit such as network firms. The PCAOB staff is gathering and analyzing information from various sources (including from the work of a related IAASB task force[23] in which the PCAOB is participating as an official observer) to identify the potential need for standard-setting related to QC.

Audit Quality Indicators

George Wilfert, Deputy Director, Office of Economic and Risk Analysis, introduced the topic of Audit Quality Indicators (AQIs) and provided an update of the project since the Board issued its concept release.[24] The Board's current approach is to encourage and monitor the use of AQIs by firms, audit committees, and other regulators, as well as to encourage academic

[22] The International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (the "IESBA Code") has been revised to address the professional accountant's responsibility in relation to NOCLAR and became effective on July 15, 2017. The revised IESBA Code establishes a framework for professional accountants to respond to identified or suspected NOCLAR. The IAASB also updated ISA 250, *Consideration of Laws and Regulations in an Audit of the Financial Statements*, to align with those changes in the code. In addition, the AICPA's Professional Ethics Executive Committee (PEEC) proposed modifications to the Code of Professional Conduct that would require certain actions when members learn of NOCLAR in connection with their engagement or employment. The proposed interpretation is based on the PEEC's review of a new standard adopted by the IESBA.

[23] See projects related to *Quality Control at Firm Level — ISQC 1*, proposed *Engagement Quality Control Review — ISQC 2*, and ISA 220, *Quality Control at the Engagement Level*.

[24] See PCAOB Release No. 2015-005, *Concept Release on Audit Quality Indicators: Notice of Roundtable* (July 2015). Discussions in the release included: (i) the nature of the potential indicators, (ii) the usefulness of the indicators, (iii) suggestions for other indicators, (iv) potential users of the indicators, and (v) an approach to implementation over time of an AQI project. Also see Deloitte's December 10, 2015, July 14, 2015, December 10, 2013, and June 10, 2013, *Heads Up* newsletters for summary of AQIs discussion held at the previous SAG meetings.

research. Mr. Wilfert noted that the voluntary approach to AQIs could encourage creativity and innovation as well as enable auditors and audit committees to become comfortable with AQIs and gain experience with them as a decision-making tool. He also stated that AQIs might enhance dialogue between auditors and audit committees and promote competition on audit quality. However, some stakeholders are proponents of the PCAOB undertaking rule-making with respect to AQIs in order to provide a standardized framework and definitions that may further promote comparability and objectivity. Other non-U.S. regulators are also encouraging and monitoring the use of AQIs. Some regulators have required firms to publish a mandatory set of AQIs, while others have adopted a more flexible, principles-based approach.[25] In recent years, some firms have begun releasing annual reports that describe how they focus on audit quality.[26]

During the panel discussion, two SAG members, an audit firm representative and an audit committee member, shared examples of firm- and engagement-level AQIs that they found to be useful in providing insights about audit quality. They also discussed how AQIs can help the audit committee fulfill its oversight responsibilities of the audit firm, but also emphasized that two-way communication between the audit committee and auditor regarding the qualitative aspects of the engagement-level AQIs is important. In addition, Robert Knechel[27] discussed his review of academic research on audit quality.[28] He noted that existing research examines, among other things, definitions and drivers of audit quality, frameworks to evaluate audit quality, and the connection between audit quality and AQIs, concluding that many academic papers suggest AQIs could be beneficial.

After the panel discussion, SAG members raised the following questions:

- Whether a framework for AQIs was needed.
- If audit committees were equipped to have discussions about AQIs.
- How AQIs are used to evaluate root causes of deficiencies.
- Which AQIs audit committees are finding most useful, noting that each audit committee has a unique perspective on what would be most useful to them.

SAG members concluded that AQIs are a starting point to facilitate a discussion among the audit committee, auditors, and management, as they need to be considered in the context of a specific company and tailored appropriately.

Professional Skepticism

Brian Degano, PCAOB staff member, introduced the panel discussion on professional skepticism.[29] The objective of the discussion was to foster dialogue about what actions the PCAOB might take to promote the auditor's use of professional skepticism.

John Fiebig, Senior Deputy Director, Division of Registration and Inspections, discussed the PCAOB's insights from inspections and deficiencies related to the application of professional skepticism, noting the following typical challenges:

- Tendency to defer to perceived expertise of the issuer.

[25] See Federation of European Accountants, *Overview of Audit Quality Indicators Initiatives, Update to December 2015 edition* (July 2016).

[26] See Deloitte's *US Audit Quality Report* (Dec. 2016).

[27] W. Robert Knechel is the director of the Center for International Research in Accounting and Auditing at the University of Florida and is a SAG member.

[28] See, e.g., W. Robert Knechel, Gopal Krishnan, Mikhail Pevzner, Lori Shefchik, and Uma Velury, "Audit Quality: Insights from the Academic Literature," *Auditing: A Journal of Practice & Theory* 32, no 1 (2013).

[29] AS 1015, *Due Professional Care in the Performance of Work*, describes professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. In 2012, the PCAOB issued Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits*, to remind auditors of their responsibilities to apply professional skepticism throughout an audit. Among other things, Practice Alert 10 describes PCAOB standards requiring the auditor to exercise professional skepticism; discusses how firms can promote professional skepticism through their quality control systems; and provides examples of requirements in PCAOB standards that require the exercise of professional skepticism.

- Failure to obtain audit evidence beyond inquiry of management.
- Failure to consider or sufficiently evaluate evidence included in work papers that may contradict an auditor's conclusion.
- Acceptance of information included in management or specialist calculations without performing procedures to verify completeness and accuracy of underlying data.

Marion Koenigs, Deputy Director, Enforcement and Investigations, discussed several recent enforcement cases in which lack of due care and professional skepticism was an overarching theme. She noted that the exercise of professional skepticism is particularly important in areas such as significant management judgments, transactions that are outside of normal course of business, related-party transactions, and auditor's consideration of fraud.

David Kane, Assurance Professional Practice, Ernst & Young, LLP, discussed key behaviors and traits needed to exercise professional skepticism:

- Being objective and inquisitive while asking questions.
- Knowing when you need help and actively seeking it.
- Planning audit work and being vigilant in assessing progress during the audit.
- Avoiding confirmation and anchoring biases.

He suggested that auditors can evidence professional skepticism through documentation, including consideration of contrary evidence, alternative assumptions, or alternative conclusions considered.

Tammie Schaefer, University of Missouri-Kansas City, discussed academic research that has been commissioned by the PCAOB related to professional skepticism. She explained that the majority of research is based upon the Nelson model,[30] which suggests that incentives, traits, and knowledge influence the extent to which auditors make skeptical judgements and take skeptical action. In addition, environmental factors, such as management actions and attitudes, are also influential. The conclusion of the research is that in order to increase skepticism there needs to be a culture where appropriate skepticism is consistently rewarded.

Reactions and comments from various SAG members included the following:

- Engagement teams, audit firms, companies, and audit committees all need to work together to promote a skeptical mindset.
- Cultural differences outside the United States may affect application of professional skepticism.
- Time constraints threaten the application of professional skepticism, and tone at the top of the audit firm is important to reinforce the need to complete quality audit work despite time pressure.
- Audit committees and audit firms – especially audit supervisors – need to (1) encourage professional skepticism and behavior that identifies risks and potential issues and then follows up on those issues, and (2) support such actions even when a reasonable explanation exists.

Mr. Baumann stated that the PCAOB is continuing to explore whether additional actions might meaningfully enhance auditor's professional skepticism, and that they will consider this issue as they are working on other projects (e.g., the PCAOB's recent standard on related parties[31]

[30] Nelson, Mark W., "A Model and Literature Review of Professional Skepticism in Auditing," *Auditing: A Journal of Practice & Theory* 28, no 2 (2009): 1-34.
[31] See AS 2410, *Related Parties*.

emphasizes the need for professional skepticism and the proposed standard on auditing accounting estimates[32] builds the concept of professional skepticism into the standard).

FASB Rulemaking and Implementation Activities

Mr. Baumann introduced the panel discussion on recent FASB accounting pronouncements and their effects on audits. Susan Cosper, FASB Technical Director, gave an overview of the new accounting standards, including revenue recognition,[33] leases,[34] credit losses,[35] and hedge accounting,[36] and implementation issues and questions FASB has received related to these standards. After Ms. Cosper's presentation, the panel focused on issues related to the implementation of the revenue recognition standard.

Dave Sullivan, National Managing Partner — Quality & Professional Practice, Deloitte & Touche LLP, discussed his view of the four phases of implementing any new standard: (i) understand, educate, plan; (ii) assess; (iii) implement; and (iv) reassess, evaluate, sustain. He also shared the importance of the following steps when implementing any new standard:

- Spending the time upfront to understand the accounting, plan the implementation, and build the foundation before implementing the new accounting standard.
- Involving auditors, as it is important for auditors to understand management's processes and to be able to plan the audit appropriately.

Mr. Sullivan also discussed various management readiness activities that are necessary to implement a new accounting standard as follows:

- Considering the impact on other functions such as accounting, tax, finance/treasury, and information technology.
- Planning for proper resources dedicated to the implementation.
- Having a process and controls established for (1) the implementation effort itself, (2) the transition to the new rules, and (3) the ongoing accounting post-adoption.

He also pointed out activities that are critical for auditors to consider when developing a plan to audit implementation of a new accounting standard, such as technical training, risk assessment, internal controls,[37] and disclosures.

Wendy Stevens, Quality Assurance Practice leader at Mazars, discussed revenue recognition efforts from a small audit firm perspective, noting that smaller companies may not be as far along in implementation and identified some of the challenges they are facing, including resource constraints.

Sandy Peters, CFA Institute, discussed some of the investor considerations related to the new revenue recognition standard, including:

- The need for investors to understand what changes to expect.
- How particular industries will be affected.
- The disclosures the company is making regarding the impact of adoption on various ratios and NGFMs.

32 PCAOB Release No. 2017-002, *Auditing Accounting Estimates, Including Fair Value Measurements*.
33 FASB Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*.
34 FASB Accounting Standards Update No. 2016-02, *Leases (Topic 842)*.
35 FASB Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.
36 FASB Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.
37 See Deloitte's May 9, 2017, *Heads Up* newsletter, which highlights the internal control considerations related to adoption of the new revenue recognition standard.

Some SAG members expressed their concerns around "standards overload," the risk it introduces into financial reporting system, and the costs associated with implementation of the new standards. However, one SAG member pointed out the positive side of required accounting changes, including the opportunity for enhanced conversations between audit committees and auditors about audit quality. He also discussed the potential for improved financial reporting due to the upfront involvement by auditors and audit committees.

IAASB Update

Arnold Schilder, Chairman of the IAASB, and Megan Zietsman, in her capacity as IAASB Deputy Chair, provided SAG with an overview of the standard-setting agenda of the IAASB, highlighting how IAASB's current projects related to quality control,[38] risk identification and assessment,[39] auditing accounting estimates,[40] and group audits[41] contribute to strengthening the application of professional skepticism[42] and enhancing audit quality.

[38] See projects related to ISQC 1, *Quality Control at Firm Level*, proposed ISQC 2, *Engagement Quality Control Review*, and ISA 220, *Quality Control at the Engagement Level*.

[39] See project related to ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*.

[40] See project related to ISA 540, *Auditing Accounting Estimates*.

[41] See project related to ISA 600, *Group Audits*.

[42] See August 2017 publication from a working group with representatives from the IAASB, the International Ethics Standards Board for Accountants, and the International Accounting Education Standards Board, *Toward Enhanced Professional Skepticism*.