

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-67807; File No. PCAOB-2012-001)**

**September 10, 2012**

**Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standard No. 16, Communications with Audit Committees and Related and Transitional Amendments to PCAOB Standards**

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), notice is hereby given that on August 28, 2012, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On August 15, 2012, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*, related amendments to its interim auditing standards, and transitional amendments to AU sec. 380, *Communication with Audit Committees*, (collectively, "the proposed rules"). The text of the proposed rules is set out below.

**Auditing Standard No. 16**

*Communications with Audit Committees*

*Introduction*

1. This standard requires the auditor to communicate with the company's **audit committee**<sup>1</sup> regarding certain matters related to the conduct of an audit<sup>2</sup> and to obtain

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<sup>1</sup> Terms defined in Appendix A, *Definitions*, are set in boldface type the first time they appear.

certain information from the audit committee relevant to the audit. This standard also requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee and to record that understanding in an engagement letter.

2. Other Public Company Accounting Oversight Board ("PCAOB") rules and standards identify additional matters to be communicated to a company's audit committee (see Appendix B). Various laws or regulations also require the auditor to communicate certain matters to the audit committee.<sup>3</sup> The communication requirements of this standard do not modify or replace communications to the audit committee required by such other PCAOB rules and standards, and other laws or regulations. Nothing in this standard precludes the auditor from communicating other matters to the audit committee.

### ***Objectives***

3. 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

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<sup>2</sup> For purposes of this standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

<sup>3</sup> See e.g., Section 10A(k) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j-1(k); Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. § 240.10A-3.

- d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

Note: "Communicate to," as used in this standard, is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

### ***Appointment and Retention***

#### **Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention**

4. The auditor should discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

#### **Establish an Understanding of the Terms of the Audit**

5. The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:
  - a. The objective of the audit;
  - b. The responsibilities of the auditor; and
  - c. The responsibilities of management.
6. The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually. The auditor should have the engagement letter executed by the appropriate

party or parties on behalf of the company.<sup>4</sup> If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Note: Appendix C describes matters that the auditor should include in the engagement letter about the terms of the audit engagement.

7. If the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept, continue, or perform the engagement.

### **Obtaining Information and Communicating the Audit Strategy**

#### **Obtaining Information Relevant to the Audit**

8. The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit,<sup>5</sup> including, but not limited to, violations or possible violations of laws or regulations.<sup>6</sup>

### **Overall Audit Strategy, Timing of the Audit, and Significant Risks**

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<sup>4</sup> Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

<sup>5</sup> In addition to this inquiry, paragraphs 5.f. and 54-57 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describe the auditor's inquiries of the audit committee, or equivalent (or its chair) regarding the audit committee's knowledge of the risks of material misstatement, including fraud risks. These inquiries include, among other things, whether the audit committee is aware of tips or complaints regarding the company's financial reporting.

<sup>6</sup> See AU sec. 317, *Illegal Acts by Clients*, for a description of the auditor's responsibilities when a possible illegal act is detected. For audits of issuers, see also Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and Rule 10A-1 under the Exchange Act, 17 C.F.R. § 240.10A-1.

9. The auditor should communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit,<sup>7</sup> and discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.<sup>8</sup>

Note: This overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures.

10. As part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

- a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;<sup>9</sup>
- b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;<sup>10</sup>

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<sup>7</sup> See paragraphs 8-9 of Auditing Standard No. 9, *Audit Planning*, for a description of the auditor's responsibilities for establishing an overall audit strategy.

<sup>8</sup> Auditing Standard No. 12 requires the auditor to determine whether identified and assessed risks are significant risks. A significant risk is defined as a risk of material misstatement that requires special audit consideration.

<sup>9</sup> See paragraph 16 of Auditing Standard No. 9 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

<sup>10</sup> See AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which describes the auditor's responsibilities related to the work of internal auditors.

- c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;<sup>11</sup>
- d. The names, locations, and planned responsibilities<sup>12</sup> of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

Note: The term "other independent public accounting firms" in the context of this communication includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

- e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.<sup>13</sup>

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<sup>11</sup> See paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which describe the auditor's responsibilities related to using the work of others in an audit of internal control over financial reporting.

<sup>12</sup> See paragraphs 8-14 of Auditing Standard No. 9, which discuss the auditor's responsibilities for determining the audit strategy, audit plan, and extent to which audit procedures should be performed at selected locations or business units involving multi-location engagements.

<sup>13</sup> See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which discusses the professional judgments the auditor makes in deciding whether the auditor may serve as principal auditor.

11. The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.<sup>14</sup>

### ***Results of the Audit***

#### **Accounting Policies and Practices, Estimates, and Significant Unusual Transactions**

12. The auditor should communicate to the audit committee the following matters:
- a. Significant accounting policies and practices.<sup>15</sup>
    - (1) Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and
    - (2) The effect on financial 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 in practice.
  - b. **Critical accounting policies and practices.** All critical accounting policies and practices to be used, including:<sup>16</sup>

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<sup>14</sup> See paragraph 15 of Auditing Standard No. 9, which discusses changes in audit strategy and the audit plan during the course of the audit.

<sup>15</sup> See, e.g., Financial Accounting Standards Board Accounting Standards Codification, Topic 235, Notes to Financial Statements, paragraph 235-10-50-1, which requires the entity to disclose a description of all significant accounting policies as an integral part of the financial statements, and paragraph 235-10-50-3, which describes what should be disclosed.

<sup>16</sup> See also Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), and Rule 2-07(a)(1) of Regulation S-X, 17 C.F.R. § 210.2-07(a)(1).

- (1) The reasons certain policies and practices are considered critical;  
and
- (2) How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

Note: Critical accounting policies and practices, as defined in Appendix A, are a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, 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. Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year.

c. **Critical accounting estimates.**

- (1) A description of the process management used to develop critical accounting estimates;<sup>17</sup>
- (2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;<sup>18</sup> and

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<sup>17</sup> See AU sec. 342, *Auditing Accounting Estimates*, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

<sup>18</sup> *Id.*



(3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.<sup>19</sup>

d. Significant unusual transactions.

(1) 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;<sup>20</sup> and

(2) The policies and practices management used to account for significant unusual transactions.

Note: As part of its communications to the audit committee, management might communicate some or all of the matters in paragraph 12. If management communicates any of these matters, the auditor does not need to communicate them at the same level of detail as management, as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor should communicate any omitted or inadequately described matters to the audit committee.

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<sup>19</sup> *Id.*

<sup>20</sup> *See* paragraph 71.g. of Auditing Standard No. 12.

## **Auditor's Evaluation of the Quality of the Company's Financial Reporting**

13. The auditor should communicate to the audit committee the following matters:
- a. Qualitative aspects of significant accounting policies and practices.
    - (1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements;<sup>21</sup> and
    - (2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.<sup>22</sup>
  - b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.

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<sup>21</sup> See paragraphs 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*, which describe the auditor's responsibilities related to evaluating the qualitative aspects of the company's accounting practices.

<sup>22</sup> See paragraph 27 of Auditing Standard No. 14.

- c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.<sup>23</sup>
- d. Significant unusual transactions. The auditor's understanding of the business rationale for significant unusual transactions.<sup>24</sup>
- e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth.<sup>25</sup>
- f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding

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<sup>23</sup> See AU sec. 342, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

<sup>24</sup> See paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>25</sup> See paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibilities related to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Other PCAOB standards, such as AU sec. 334, *Related Parties*, and AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describe the auditor's responsibilities related to evaluation of specific disclosures in financial statements.

management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.

- g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.<sup>26</sup>

#### **Other Information in Documents Containing Audited Financial Statements**

14. When other information is presented in documents containing audited financial statements, the auditor should communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.<sup>27</sup>

#### **Difficult or Contentious Matters for which the Auditor Consulted**

15. The auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

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<sup>26</sup> See also Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), and Rule 2-07(a)(2) of Regulation S-X, 17 C.F.R. § 210.2-07(a)(2).

<sup>27</sup> See, e.g., AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*. In addition to AU sec. 550, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information*, and AU sec. 711, *Filings Under Federal Securities Statutes*.

## **Management Consultation with Other Accountants**

16. When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation.

## **Going Concern**

17. The auditor should communicate to the audit committee, when applicable, the following matters relating to the auditor's evaluation of the company's ability to continue as a going concern:<sup>28</sup>

- a. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt;<sup>29</sup>
- b. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including

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<sup>28</sup> See AU sec. 341 for the requirements regarding an auditor's responsibility to evaluate whether there is substantial doubt about a company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Additionally, AU secs. 341.03a-c provide the auditor with an overview of the requirements for evaluating whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

<sup>29</sup> See AU sec. 341.06, which provides examples of such conditions and events and AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events;<sup>30</sup>

c. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:<sup>31</sup>

(1) The effects, if any, on the financial statements and the adequacy of the related disclosure;<sup>32</sup> and

(2) The effects on the auditor's report.<sup>33</sup>

### **Uncorrected and Corrected Misstatements**

18. The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures<sup>34</sup> that the auditor presented to

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<sup>30</sup> See AU sec. 341.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

<sup>31</sup> See AU sec. 341.12, which describes the effects on the auditor's report. See also AU sec. 341.03c, which discusses the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

<sup>32</sup> See AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

<sup>33</sup> See AU secs. 341.12-.16, which discuss the auditor's consideration of the effects on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

<sup>34</sup> Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include omission and presentation of inaccurate or incomplete disclosures.

management.<sup>35</sup> The auditor should discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors<sup>36</sup> considered. The auditor also should communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

19. The auditor should communicate to the audit committee those corrected misstatements, other than those that are clearly trivial,<sup>37</sup> related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

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<sup>35</sup> See Section 13(i) of the Exchange Act, 15 U.S.C. § 78m(i), which states, in part, that financial statements prepared in accordance with generally accepted accounting principles and filed with the Securities and Exchange Commission "shall reflect all material correcting adjustments that have been identified by a registered public accounting firm ...."

<sup>36</sup> Appendix B of Auditing Standard No. 14 discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

<sup>37</sup> See paragraph 10 of Auditing Standard No. 14, which requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.

### **Material Written Communications**

20. The auditor should communicate to the audit committee other material written communications between the auditor and management.<sup>38</sup>

### **Departure from the Auditor's Standard Report**

21. The auditor should communicate to the audit committee the following matters related to the auditor's report:

- a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and
- b. When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.

### **Disagreements with Management**

22. The auditor should communicate to the audit committee any 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 auditor's report. Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

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<sup>38</sup> See also Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k) and Rule 2-07(a)(3) of Regulation S-X, 17 C.F.R. § 210.2-07 (a)(3).



## **Difficulties Encountered in Performing the Audit**

23. The auditor should communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

- a. Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;
- b. An unreasonably brief time within which to complete the audit;
- c. Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;
- d. Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and
- e. Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,<sup>39</sup> which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

## **Other Matters**

24. The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting

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<sup>39</sup> See paragraphs .22-.32 of AU sec. 508, *Reports on Audited Financial Statements*, for a discussion of scope limitations.

process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.<sup>40</sup>

***Form and Documentation of Communications***

25. The auditor should communicate to the audit committee the matters in this standard, either orally or in writing,<sup>41</sup> unless otherwise specified in this standard. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.<sup>42</sup>

Note: If, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs 12 or 18 and, as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor must include a copy of or a summary of management's communications provided to the audit committee in the audit documentation.

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<sup>40</sup> AU secs. 316.79-.81 and AU sec. 317.17 include specific communication requirements relating to fraud or illegal acts, respectively.

<sup>41</sup> See paragraphs .07-.11 of AU sec. 532, *Restricting the Use of an Auditor's Report*, which apply to certain written reports on matters coming to the auditor's attention during the course of the audit.

<sup>42</sup> Consistent with the requirements of Auditing Standard No. 3, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

## ***Timing***

26. All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report.<sup>43</sup> The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit.

The auditor, however, should communicate such matters to the audit committee prior to the issuance of the auditor's report.

## **APPENDIX A – Definitions**

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Audit committee – A committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company.

For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and

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<sup>43</sup> Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

financial reporting processes of the company and audits of the financial statements of the company.

A3. Critical accounting estimate – An accounting 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.

A4. Critical accounting policies and practices – A company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, 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.

## **APPENDIX B – Communications with Audit Committees Required by Other**

### **PCAOB Rules and Standards**

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.

- Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, paragraphs 60, 62, and 64
- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraphs 78-81, 91, C7, and C14
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 5.f. and 54-57

- PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*
- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79-.81
- AU sec. 317, *Illegal Acts by Clients*, paragraphs .08, .17, and .20
- AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, paragraphs 4-7 and 9
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .50
- AU sec. 333, *Management Representations*, paragraph .05
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 and .06
- AU sec. 711, *Filings Under Federal Securities Statutes*, paragraph .13
- AU sec. 722, *Interim Financial Information*, paragraphs .08-.09, .30-.31, and .33-.36

**APPENDIX C – Matters Included in the Audit Engagement Letter**

C1. The auditor should include the following matters in the engagement letter.<sup>44</sup> The auditor's description of these matters will vary depending on whether the auditor is engaged in a financial statement audit or in an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

- a. The objective of the audit is:
  1. Integrated audit: The expression of an opinion on both the effectiveness of internal control over financial reporting and the financial statements.
  2. Audit of financial statements: The expression of an opinion on the financial statements.
- b. Auditor's responsibilities:
  1. The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:
    - a. Integrated audit: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects. Accordingly, there is some risk that a

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<sup>44</sup> Certain matters should not be included in an engagement letter; for example, under Securities and Exchange Commission, *Section 602.02.f.i. of the Codification of Financial Reporting Policies*, indemnification provisions are not permissible for audits of issuers.

material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

**b. Audit of financial statements:** Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not

formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

2. An audit includes:
  - a. Integrated audit: In fulfillment of the responsibilities noted above, the auditor communicates:
    1. To the audit committee and management: all material weaknesses in internal control over financial reporting identified during the audit, in writing.
    2. To the audit committee: all significant deficiencies identified during the audit, in writing, and informs the audit committee when the auditor has informed management of all internal control deficiencies.
    3. To management: all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others within the company.
    4. To the board of directors: any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, in writing.



- b. Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed.<sup>45</sup> An audit of financial statements is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating:
1. To the audit committee and management: all significant deficiencies and material weaknesses identified during the audit, in writing.
  2. To the board of directors: if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion, in writing.
- c. Management's responsibilities:
1. Management is responsible for the company's financial statements, including disclosures.
  2. Management is responsible for establishing and maintaining effective internal control over financial reporting.

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<sup>45</sup> AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on control deficiencies identified in an audit of financial statements.

3. Management is responsible for identifying and ensuring that the company complies with the laws and regulations applicable to its activities.
4. Management is responsible for making all financial records and relevant information available to the auditor.
5. At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.
6. Management is responsible for adjusting the financial statements to correct material misstatements relating to accounts or disclosures and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

C2. In connection with a review of interim financial information, to confirm and document the understanding, the auditor should either: (a) document in the audit engagement letter the nature and objectives of the engagement to review interim financial information and the responsibilities of management and the auditor or (b) issue a separate engagement letter that addresses such matters.<sup>46</sup>

## **Amendments to PCAOB Standards**

### **Auditing Standards**

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<sup>46</sup> Paragraphs .08-.09 of AU sec. 722, *Interim Financial Information*, discuss the auditor's responsibilities related to establishing an understanding with the audit committee in connection with a review of the company's interim financial information.

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

- a. The following sentence is added at the end of paragraph 80:  
  
This communication should be made in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.
- b. *The following sentence is added after the first sentence of paragraph 81:*  
  
The auditor should communicate this information to the audit committee in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.

Auditing Standard No. 9, *Audit Planning*

Auditing Standard No. 9, *Audit Planning*, is amended as follows:

- a. Paragraph 6.c. is replaced with:  
  
Establish an understanding of the terms of the audit engagement with the audit committee in accordance with Auditing Standard No. 16, *Communications with Audit Committees*.
- b. Footnote 4 to paragraph 6 is deleted.
- c. In footnote 7 to paragraph 9.a., the references to AU sec. 310 and AU sec. 380, *Communication with Audit Committees*, are replaced with a reference to Auditing Standard No. 16, *Communications with Audit Committees*.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material*

*Misstatement*, is amended as follows:

The note to paragraph 5.d. is deleted.

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is superseded.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

a. The third sentence of paragraph .79 is replaced with:

Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee in a timely manner and prior to the issuance of the auditor's report.

b. The second sentence of paragraph .81 is replaced with:

Such a communication may be a part of an overall communication to the audit committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the qualitative aspects of the entity's accounting policies and practices (see paragraphs 12–13 of Auditing Standard No.16, *Communications with*

*Audit Committees*). The auditor should communicate these matters to the audit committee in a timely manner and prior to the issuance of the auditor's report.

- c. Within footnote 10 to paragraph .88, the reference to section 380, *Communication With Audit Committees*, is replaced with a reference to Auditing Standard No.16, *Communications with Audit Committees*.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Clients" (AU sec. 317, "Illegal Acts by Clients"), as amended, is amended as follows:

- a. The fourth sentence of paragraph .08 is replaced with:  
  
The auditor should make inquiries of management and the audit committee concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations.
- b. Footnote 1 is added to paragraph .08 after the term "audit committee":  
  
For this standard, audit committee is defined as a committee (or equivalent body) established by and among the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity; if no such committee exists with respect to the entity, the entire board of directors of the entity. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the entity, the person(s) who oversee the accounting and financial reporting processes of the entity and audits of the financial statements of the entity.

c. The first sentence of paragraph .17 is replaced with:

The auditor should assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor's report with respect to illegal acts that come to the auditor's attention.

d. Footnote 1 to paragraph .17 is deleted.

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

Paragraph .50 is replaced with:

Paragraphs 12-13 of Auditing Standard No. 16, *Communications with Audit Committees*, require the auditor to communicate to the audit committee matters related to critical accounting estimates, which may include fair value measurements.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

The following sentence is added as the last sentence of paragraph .05:

The auditor should provide a copy of the representation letter to the audit committee if management has not already provided the representation letter to the audit committee.

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows:

Paragraph .17A is added, along with the heading preceding this paragraph:

Communications with Audit Committees

Paragraph 17 of Auditing Standard No. 16, *Communications with Audit*

*Committees*, describes matters an auditor is required to communicate to the audit committee related to the auditor's evaluation of a company's ability to continue as a going concern for a reasonable period of time.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is superseded.

AU sec. 9380, "Communication With Audit Committees: Auditing Interpretations of Section 380"

AU sec. 9380, "Communication With Audit Committees: Auditing Interpretations of Section 380," is superseded.

AU sec. 532, "Restricting the Use of an Auditor's Report"

SAS No. 87, "Restricting the Use of an Auditor's Report (AU sec. 532, "Restricting the Use of an Auditor's Report"), as amended, is amended as follows:

In the second bullet point of paragraph .07, the reference to Section 380, *Communication With Audit Committees*, is replaced with a reference to Auditing Standard No. 16, *Communications with Audit Committees*.

AU sec. 550, "Other Information in Documents Containing Audited Financial Statements"

SAS No. 8, "Other Information in Documents Containing Audited Financial Statements" (AU sec. 550, "Other Information in Documents Containing Audited Financial Statements"), as amended, is amended as follows:

- a. The sixth sentence of paragraph .04 is replaced with:

If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement.

- b. The second sentence of paragraph .06 is replaced with:

He should communicate the material misstatement of fact to the client and the audit committee, in writing, and consider consulting his legal counsel as to further appropriate action in the circumstances.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), as amended, is amended as follows:

- The last sentence of paragraph .13 is replaced with:

In either case, the accountant should communicate the matter to the audit committee and also consider withholding his consent to the use of his report on the audited financial statements in the registration statement.



AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. The heading preceding paragraph .08, "Establishing an Understanding With the Client" is replaced with the heading, "Establishing an Understanding with the Audit Committee."

- b. Paragraph .08 is replaced with:

The accountant should establish an understanding of the terms of an engagement to review interim financial information with the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee).<sup>6</sup> This understanding includes the objective of the review of interim financial information, the responsibilities of the accountant, and the responsibilities of management. Such an understanding reduces the risk that either the accountant or the audit committee may misinterpret the needs or expectations of the other party. The accountant should record this understanding of the terms of the engagement in an engagement letter and should provide the engagement letter to the audit committee. The accountant should have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the accountant should determine that the audit committee has acknowledged and agreed to the terms of the engagement. If the accountant believes he or she

cannot establish an understanding of the terms of an engagement to review interim financial information with the audit committee, the accountant should decline to accept, continue, or perform the engagement.

- c. Footnote 6 to paragraph .08 is replaced with:

*See paragraph .16 of QC sec. 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice.*

- d. In the first sentence of paragraph .09, the word "client" is replaced with the words "audit committee."

- e. Paragraph .30 is replaced with:

If management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should communicate these matters to the audit committee as soon as practicable and prior to the registrant filing its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 25 of Auditing Standard No. 16, *Communications with Audit Committees*.

- f. The following sentence is added at the end of paragraph .33:

The accountant should communicate significant deficiencies or material weaknesses of which the accountant has become aware to the audit committee or those responsible for oversight of the company's financial reporting in a timely manner and prior to the registrant filing its periodic report with the SEC.

- g. Paragraph .34 is replaced with:

When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in Auditing Standard No. 16, *Communications with Audit Committees*, as they relate to interim financial information, have been identified. If such matters have been identified, the accountant should communicate them to the audit committee in a timely manner and prior to the registrant filing its periodic report with the SEC. For example, the accountant should communicate a description of the process management used to develop the critical accounting estimates; a change in a significant accounting policy affecting the interim financial information; misstatements that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and uncorrected misstatements aggregated by the accountant that management determined to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole.<sup>23</sup> As part of its communications to the audit committee, management might communicate some or all of the matters related to the company's accounting policies, practices, estimates, and significant unusual transactions described in paragraph 12 of Auditing Standard No. 16, *Communications with the Audit Committees*. If management communicates any of these matters, the accountant does not need to communicate them at the same level of detail as management, as long as the accountant (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that

management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the accountant considers critical. The accountant should communicate any omitted or inadequately described matters to the audit committee.

- h. Footnote 23 to paragraph .34 is replaced with:

The schedule of uncorrected misstatements related to accounts and disclosures provided to the audit committee should be the same schedule that was included in or attached to the management representation letter that is described in paragraph .24(k) of this section.

- i. The last two sentences of paragraph .35 are replaced with:

Therefore, any communication the accountant may make about the entity's accounting policies, practices, estimates, and significant unusual transactions as applied to its interim financial reporting, generally would be limited to the effect of significant events, transactions, and changes in accounting estimates that the accountant considered when conducting the review of interim financial information. Further, interim review procedures do not provide assurance that the accountant will become aware of all matters that might affect the accountant's judgments about the qualitative aspects of the entity's accounting policies and practices that would be identified as a result of an audit.

- j. Paragraph .36 is replaced with:

If the accountant has identified matters to be communicated to the audit committee, the accountant should communicate such matters to the audit committee, or at least its chair, in a timely manner and prior to the registrant filing its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 25 of Auditing Standard No. 16, *Communications with Audit Committees*.

**Transitional Amendments to AU sec. 380, Communication With Audit Committees**

AU sec. 380, *Communication With Audit Committees*

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows:

- a. The last sentence of paragraph .01 is replaced with:  
  
The communications required by this section are applicable to the audits of (i) issuers and (ii) brokers and dealers, as those terms are defined in the Sarbanes-Oxley Act of 2002, as amended.<sup>2</sup>
- b. Footnote 2 to paragraph .01 is replaced with:  
  
*See* Sections 2(a)(7), 110(3), and 110(4) of the Sarbanes-Oxley Act of 2002.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified

in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements. The Board is also requesting that the Commission approve the proposed rules, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, for application to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act"). The Board's request is set forth in section D.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Sarbanes-Oxley Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] [Sarbanes-Oxley] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." The Board adopted Auditing Standard No. 16, *Communications with Audit Committees* (the "standard"), and related amendments to improve the audit by enhancing communications between auditors and audit committees.

As discussed more fully in Exhibit 3, the Board adopted Auditing Standard No. 16 because it believes that the standard is in the public interest because the standard establishes requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors.

With the passage of the Sarbanes-Oxley Act and the establishment of the PCAOB, Congress acknowledged that auditors play an important role in protecting the interests of investors by preparing and issuing informative, accurate, and independent audit reports.<sup>47</sup> The audit committee<sup>48</sup> also plays an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to a company's shareholders and others to oversee the integrity of a company's accounting and financial reporting processes and audits. The audit committee, among other things, serves as the board of director's principal interface with the company's auditors and facilitates communications between the company's board of directors, its management, and its independent auditors on significant accounting issues and policies. The roles of auditors and audit committees are critical to the efficiency and integrity of the capital markets.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports. Communications between the auditor and the audit committee allow the audit committee to be well-informed about accounting and disclosure matters, including the

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<sup>47</sup> See Section 101(a) of the Sarbanes-Oxley Act, 15 U.S.C. § 7211(a); Senate Report No. 107-206, at 5-6 (July 3, 2002).

<sup>48</sup> The term "audit committee," as defined in Auditing Standard No. 16, is a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

auditor's evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role. Communications with the audit committee provide auditors with a forum separate from management to discuss matters about the audit and the company's financial reporting process.

Auditing Standard No. 16 is aligned with the requirements of the Sarbanes-Oxley Act. For many public companies, the Sarbanes-Oxley Act served to strengthen and expand the role of the audit committee in the financial reporting process. For example, the Sarbanes-Oxley Act requires that audit committee members of listed companies be independent and that audit committees be responsible for the appointment, compensation, and oversight of the work of the external auditor for the purpose of preparing or issuing an audit report or related work.<sup>49</sup> These requirements place the audit committee at the center of the relationship between management of a public company and its auditor.

Auditing Standard No. 16 is intended to improve the audit<sup>50</sup> by fostering constructive dialogue between the auditor and the audit committee about significant audit and financial statement matters. The standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process. Effective two-way communication between the auditor and

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<sup>49</sup> See Section 301 of the Sarbanes-Oxley Act and Section 10A(m)(2) of the Exchange Act, 15 U.S.C. § 78j-1(m)(2).

<sup>50</sup> For purposes of this release and standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.



the audit committee on such relevant matters also will benefit the auditor in performing an effective audit.

Auditing Standard No. 16 encourages 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. Communications that are tailored to the circumstances and informative, rather than "boiler-plate" or standardized, will enable the auditor and the audit committee to engage in a dialogue that is more likely to benefit both the audit committee, in conducting its oversight responsibilities, and the auditor, in conducting an effective audit. Effective communication between the auditor and the audit committee may involve many forms of communication, such as presentations, charts, written reports, or robust discussions.

AU sec. 380, which became effective in January 1989, indicated that audit committee communications are incidental to the audit and are not required to occur prior to the issuance of the auditor's report. In contrast, Auditing Standard No. 16 recognizes the importance of the auditor's communications with the audit committee in today's business and regulatory environment; therefore, Auditing Standard No. 16 requires the auditor to communicate the audit strategy and results of the audit to the audit committee in a timely manner and prior to the issuance of the auditor's report to provide an opportunity for the audit committee and the auditor to take appropriate action to address the matters communicated.

Timely communications with the audit committee help the auditor improve the audit by, among other things (i) informing the audit committee, which has responsibility for the oversight of financial reporting, about significant matters related to the audit and

the financial statements, (ii) enabling the auditor to obtain the audit committee's insights and information about transactions and events, (iii) enabling the auditor to learn about complaints regarding accounting or auditing matters, and (iv) assisting the auditor in gaining a better understanding of the company and its control environment.

Auditing Standard No. 16 generally links the new communication requirements to the results of related audit performance requirements in other PCAOB standards, or the conduct of the audit. The standard does not otherwise impose new performance requirements, other than communications. Because other PCAOB standards already require the auditor to perform procedures underlying the communications required in Auditing Standard No. 16, and the standard primarily requires communication of the results of the auditor's procedures, the Board does not anticipate a significant increase in cost as a result of the implementation of the standard.

Some of the matters to be communicated under Auditing Standard No. 16 relate specifically to matters involving management's preparation of the company's financial statements. In many companies, management might communicate these matters or take the lead on communicating these matters to the audit committee. The PCAOB does not have the authority to require management to communicate to the audit committee. Additionally, certain communications by the auditor are mandated by federal securities laws and Commission rules.<sup>51</sup> Therefore, Auditing Standard No. 16 establishes required communications by the auditor to the audit committee but, at the same time, clearly recognizes and acknowledges that management might communicate to the audit

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<sup>51</sup> See e.g., Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k); SEC Rule 2-07 of Regulation S-X ("SEC Rule 2-07"), 17 C.F.R. § 210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. § 240.10A-3.

committee certain matters related to the company's financial statements. In such circumstances, the auditor does not need to communicate those matters at the same level of detail as management, as long as certain conditions are met, as specified in the standard.

Auditing Standard No. 16 is scalable for audits of companies of various sizes and complexities. A company's size and complexity might affect the risks of misstatements, the audit strategy, and other significant matters that warrant the attention of the audit committee. Based on the specific company's circumstances, the standard requires communications only to the extent that the matters are relevant to the audit of the financial statements of the company or of internal control over financial reporting. For example, an auditor of a smaller, less complex company with fewer difficult auditing or financial reporting issues may have fewer matters to communicate than the auditor of a larger, more complex company.

The proposed rules also amend the Board's interim standards including superseding interim standards AU sec. 380, *Communication With Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor* ("AU sec. 310").

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Sarbanes-Oxley Act.

B. Board's Statement on Burden on Competition

Not applicable.

C. Board's Statement on Comments on the Proposed Rules Change Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2010-001 (March 29, 2010). The Board received 35 comment letters. On September 21, 2010, the Board held a roundtable to obtain insight from additional stakeholders, including investors, audit committee members, auditors, and preparers. The Board reopened the public comment period on the original proposed rules to allow for interested parties to provide additional comments on the topics discussed at the roundtable. The Board received nine additional comment letters during this extended comment period.

The Board considered the comments received relating to its initial proposed rules and at the roundtable and made changes to the initial proposed rules. As a result, the Board again sought public comment on the proposed rules on December 20, 2011. The Board received 39 written comment letters relating to its reproposal of the proposed rules.

The Board has carefully considered all comments received. The Board's response to the comments it received and the changes made to the rules in response to the comments received are discussed below.

### **Overview of Auditing Standard No. 16**

Auditing Standard No. 16 provides a definition of audit committee, retains or enhances existing communication requirements, incorporates certain SEC auditor communication requirements to audit committees, and adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

For audits of issuers, Auditing Standard No. 16 incorporates the Sarbanes-Oxley Act's definition of audit committee as a committee (or equivalent body) established by

and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, then the audit committee is the entire board of directors of the company. For audits of nonissuers, the definition of audit committee contained in Auditing Standard No. 16 provides that if no audit committee or board of directors (or equivalent body) exists with respect to the company, then the audit committee is the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

AU sec. 310 requires the auditor to establish an understanding with the client regarding the services to be performed. Auditing Standard No. 16 requires the auditor to establish the understanding of the terms of the audit engagement with the audit committee. This requirement aligns the auditing standard with the provision of the Sarbanes-Oxley Act that requires the audit committee of listed companies to be responsible for the appointment of the external auditor.<sup>52</sup>

Additionally, Auditing Standard No. 16 requires the auditor to record the terms of the engagement in an engagement letter and to have the engagement letter executed by the appropriate party or parties on behalf of the company and determine that the audit committee has acknowledged and agreed to the terms. These requirements are an expansion of the requirement in AU sec. 310 for the auditor to document the

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<sup>52</sup> See Section 301 of the Sarbanes-Oxley Act, and Sections 10A(m)(2) of the Exchange Act, 15 U.S.C. § 78j-1(m)(2).

understanding in the working papers, preferably through a written communication with the client.

Auditing Standard No. 16 retains many of the communication requirements in AU sec. 380 and also incorporates the SEC communication requirements.<sup>53</sup> The standard improves the current communication requirements of AU sec. 380 by requiring the communications with the audit committee to occur before the issuance of the audit report. Additionally, the standard enhances certain existing auditor communication requirements by requiring the auditor to communicate:

- Certain matters regarding the company's accounting policies, practices, and estimates;
- The auditor's evaluation of the quality of the company's financial reporting;
- Information related to significant unusual transactions, including the business rationale for such transactions; and
- The auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters.

Auditing Standard No. 16 expands the inquiries of the audit committee required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, which requires the auditor to inquire of the audit committee regarding the matters

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<sup>53</sup> See Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k) and SEC Rule 2-07(a)(1)-(3).

important to the identification and assessment of risks of material misstatement and fraud risks. The additional inquiries in Auditing Standard No. 16 address whether the audit committee is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations.

Additionally, Auditing Standard No. 16 adds new communication requirements that provide the audit committee with additional information about significant aspects of the audit. These communications are generally linked to the results of the audit procedures or the conduct of the audit. Under Auditing Standard No. 16 the auditor would be required to communicate:

- An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
- Information about the nature and extent of specialized skill or knowledge needed in the audit, the extent of the planned use of internal auditors, company personnel or other third parties, and other independent public accounting firms, or other persons not employed by the auditor that are involved in the audit;
- The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
- Situations in which the auditor identified a concern regarding management's anticipated application of accounting pronouncements that

have been issued but are not yet effective and might have a significant effect on future financial reporting;

- Difficult or contentious matters for which the auditor consulted outside the engagement team;
- The auditor's evaluation of going concern;
- Departure from the auditor's standard report; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit.

In addition to the communication requirements included in Auditing Standard No. 16, other PCAOB standards and rules that require the auditor to communicate specific matters to the audit committee are referenced in Appendix B to Auditing Standard No. 16.

While the standard establishes certain requirements regarding auditor communications to the audit committee, Auditing Standard No. 16 does not preclude the auditor from providing additional information to the audit committee. Nor does the standard preclude the auditor from responding to audit committee requests for additional information from the auditor.

**Definition of Audit Committee (Paragraph A-2 of Auditing Standard No. 16)**

Auditing Standard No. 16 defines an audit committee as a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company



and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. This definition largely incorporates the definition of "audit committee" from the Sarbanes-Oxley Act.<sup>54</sup> The parenthetical phrase "or equivalent body" after the term "committee" clarifies that entities with bodies performing a function similar to that of an audit committee would fit within this category.

The standard modifies the Sarbanes-Oxley Act's version of the definition of an audit committee as it relates to audits of nonissuers. Specifically, for audits of nonissuers, Auditing Standard No. 16 states that, if no such committee or board of directors (or equivalent body) exists with respect to the company, the audit committee would be considered the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company. This modification was made to recognize that some nonissuers, including brokers and dealers, may have governance structures that do not include boards of directors or audit committees. In those cases, the auditor would identify those persons at the nonissuer company who oversee the company's accounting and financial reporting processes and audits. This modification is meant to indicate that senior persons in an oversight role in such circumstances would be the recipients of the auditor communications.

Using the definition of "audit committee," the auditor would identify the bodies or persons that oversee the company's accounting, auditing, and financial reporting

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<sup>54</sup> Section 2(a)(3) of the Sarbanes-Oxley Act, 15 U.S.C. § 7201.

processes to find the appropriate recipient of the communications under the standard.<sup>55</sup> For issuers, the definition is the same as the definition included in the Sarbanes-Oxley Act.<sup>56</sup> For nonissuers, the definition contains three categories of bodies or persons. The first two categories (audit committee and the entire board of directors of the company) are the same as those included in the definition of audit committee for an issuer. The third category covers situations in which the company does not have an audit committee, board of directors, or equivalent body, such as certain non-public brokers and dealers. The parenthetical phrase "or equivalent body" after the term "board of directors" clarifies that entities with bodies performing a function similar to that of a corporate board of directors would fit within this category.

The repropoed standard required the auditor to communicate to those persons designated to oversee the financial reporting processes of the company in situations in which a nonissuer does not have an audit committee, board of directors, or equivalent body. Some commenters indicated that, for certain nonissuers, the person designated to oversee the accounting and financial reporting processes of the company could be the chief financial officer, in which case the communication would be made to the person preparing the financial statements. Therefore, commenters suggested that the auditor should make relevant communications to the chief executive officer, or equivalent officer of the company.

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<sup>55</sup> The Board's proposed definition is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, or an entity's governing documents regarding the establishment, approval, or ratification of board of directors or audit committees, or the delegation of responsibilities of such a committee or board.

<sup>56</sup> Section 2(a)(3) of the Sarbanes-Oxley Act, 15 U.S.C. § 7201.

Some commenters suggested that the standard should clarify to whom the auditor should communicate when the company is a subsidiary of another entity. Auditing Standard No. 16 does not require communication outside the governance structure of the audited entity because the standard designates the appropriate party to receive the auditor communications within the audited entity. If directed by the audit client, or if the auditor otherwise deems it appropriate, the auditor could also communicate to a parent company audit committee or equivalent body.

**Objectives (Paragraph 3 of Auditing Standard No. 16)**

Auditing Standard No. 16 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 objectives of the standard are intended to highlight the overall context for the requirements in the standard.

**Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention (Paragraph 4 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the

application of accounting principles and auditing standards. This requirement was retained from AU sec. 380.<sup>57</sup>

This requirement is included in the standard because the audit committee might ask management for its views concerning the appointment or retention of the auditor. Management's views might be influenced by the interaction between the auditor and management and the auditor's evaluations and conclusions regarding the application of accounting principles or auditing standards.

Some commenters suggested that these discussions should include a robust fee discussion or a discussion about the results of the auditor's considerations during the client acceptance and continuance process, such as the auditor's views of the entity's accounting and financial reporting practices or management's integrity. The standard was not revised to include such additional matters because the requirement in the standard specifically addresses the auditor's discussions with management related to accounting and auditing matters in connection with the appointment or retention of the auditor. However, Auditing Standard No. 16 requires the auditor to communicate any matters arising from the audit to the audit committee that the auditor believes are significant to the audit committee's oversight of the company's financial reporting process.<sup>58</sup>

**Establish an Understanding of the Terms of the Audit (Paragraphs 5-7 of Auditing Standard No. 16)**

Auditing Standard No. 16 includes a specific requirement for the auditor to establish an understanding of the terms of the audit engagement with the audit committee. Having a mutually clear understanding of the terms of the engagement, including the

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<sup>57</sup> AU sec. 380.15.

<sup>58</sup> Paragraph 24 of Auditing Standard No. 16.

objectives of the audit, the responsibilities of the auditor, and the responsibilities of management in connection with the audit, should benefit both the auditor and the audit committee.

The requirement in Auditing Standard No. 16 is similar to the requirement in AU sec. 310, *Appointment of the Independent Auditor* ("AU sec 310"), which requires the auditor to establish an understanding with the client regarding the services to be performed. However, Auditing Standard No. 16 more specifically requires that the understanding be with the audit committee due to the audit committee's financial reporting and audit oversight role, rather than with the "client," which could be understood to mean others besides the audit committee in certain circumstances.

Auditing Standard No. 16 also requires the auditor to record the understanding of the terms of the audit engagement in an engagement letter. Appendix C of Auditing Standard No. 16 describes matters that should be included in an engagement letter, including the objective of the audit and the responsibilities of the auditor and management. This is an expansion of the requirement in AU sec. 310, which requires the auditor to document the understanding of the engagement in the working papers, preferably through a written communication with the client.

Some commenters indicated that the engagement letter should describe the responsibilities of the audit committee related to the audit. The Board considered this suggestion and did not change the standard to include the responsibilities of the audit committee, as those responsibilities are governed by the rules of other organizations, such

as the Commission and the national securities exchanges.<sup>59</sup> However, the standard does not prohibit the auditor from including other matters in the engagement letter, as agreed upon by the auditor and the audit committee, so long as those matters are not in violation of other standards or rules, for example, independence requirements.

Auditing Standard No. 16 requires the auditor to provide the engagement letter to the audit committee annually. Additionally, the auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company.<sup>60</sup> The standard also states that if the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor also should determine that the audit committee has acknowledged and agreed to the terms of the engagement. This acknowledgment may be obtained in a variety of ways, such as obtaining the audit committee members' signatures, or its chair's signature on behalf of the audit committee, or obtaining another form of acknowledgement and agreement by the audit committee regarding the terms of the audit engagement. Obtaining this acknowledgement reduces the risk that either the auditor or the audit committee might misinterpret the needs or expectations of the other party. An acknowledgement by the audit committee, the signatures of the audit committee members, or the signature of its chair on behalf of the audit committee on the engagement letter is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, applicable exchange requirements, or the company's governing documents,

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<sup>59</sup> See, e.g., New York Stock Exchange, Listed Company Manual at Section 303A.07, Audit Committee Additional Requirements.

<sup>60</sup> Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

regarding the authority or lack of authority of the audit committee to enter into any contract or agreement with the auditor.

Several commenters suggested that the standard should specify that the engagement letter should be executed by management in addition to the audit committee or by management alone, along with a representation that it has the authority to do so on behalf of the audit committee. The Board considered these comments and decided that, absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter. Therefore, the standard does not specify the party that should execute the engagement letter on behalf of the company.

Some commenters suggested that the standard should indicate that the audit committee's acknowledgement can be either written or oral. Other commenters suggested that the audit committee's acknowledgement should be written, either evidenced by a signature on the engagement letter or in the audit committee's minutes, to avoid the potential for subsequent misunderstandings of whether the audit committee's acknowledgement has been obtained.

The Board considered these comments and determined that the audit committee's acknowledgement may be provided in writing, such as a signed engagement letter or through the minutes of the audit committee meeting, or orally. The primary focus of this requirement is that the auditor receives acknowledgment and agreement from the audit committee rather than the method the audit committee uses to provide that acknowledgement; therefore, a change to the standard was not warranted. The repropoed standard did not specify the form of acknowledgment and, therefore, the standard was not

revised. However, the auditor could request that the audit committee acknowledge the terms of the audit engagement in writing. If the audit committee's acknowledgement is received orally, in accordance with paragraph 25 of Auditing Standard No. 16, the auditor is required to document the acknowledgement in the auditor's work papers.

**Obtaining Information Relevant to the Audit (Paragraph 8 of Auditing Standard No. 16)**

Auditing Standard No. 16 includes a requirement for the auditor to inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations. This inquiry contributes to a two-way dialogue between the auditor and the audit committee concerning matters relevant to the audit. This inquiry would complement the requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks, in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.<sup>61</sup> This requirement is included in the standard because, in addition to the inquiries required as part of the risk assessment procedures, audit committees may be aware of other matters relevant to the auditor in performing audit procedures.

Auditing Standard No. 16 does not include the reference to "complaints or concerns received by the audit committee regarding financial reporting matters" previously included in the repropoed standard. This change is not intended to signal a change in the scope of this communication between the audit committee and the auditor. Rather, the Board notes that such inquiry by the auditor of the audit committee is already included in paragraph 56.b(3) of Auditing Standard No. 12, which requires the auditor to

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<sup>61</sup> See paragraph 5.f. and 54-57 of Auditing Standard No. 12.



inquire of the audit committee about tips or complaints regarding the company's financial reporting.<sup>62</sup> Since the inquiry in the repropoed standard was similar to the inquiries in Auditing Standard No. 12, Auditing Standard No. 16 was revised to remove the inquiry regarding complaints or concerns.

Auditing Standard No. 16 does not provide specific timing for these inquiries to be made. Depending on the circumstances of the audit, it may be appropriate for the auditor to conduct such inquiries of the audit committee at the outset of the audit and/or at other various stages of the audit. For example, the auditor may want to conduct these inquiries early in the audit to consider any information received from the audit committee in designing the nature, timing, and extent of audit procedures. In other circumstances, as the audit progresses, an auditor may want to inquire of the audit committee as to whether any additional matters or concerns relevant to the audit have come to the attention of the audit committee not previously discussed with the auditor.

The repropoed standard required the auditor to inquire of the audit committee about "whether it is aware of matters that might be relevant to the audit." One commenter raised concerns about this provision of the repropoed standard as being "too broad and overreaching," which could obscure information that is truly relevant to the audit. Other commenters suggested that the inquiries of the audit committee should be expanded to include other matters, such as the audit committee's awareness of significant changes in company conditions or activities.

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<sup>62</sup> Auditing Standard No. 12 also includes inquiries regarding the audit committee's views about fraud risks, its knowledge of fraud, and the audit committee's response to tips or complaints regarding the company's financial reporting, and how the audit committee exercises oversight of the company's assessment of fraud risks. *See* paragraphs 56.b(1)-(4) of Auditing Standard No. 12.

After considering the comments received on the scope of the information to be communicated under this provision, the term "might be" was excluded from this paragraph of the standard. The deletion of the term "might be" is appropriate to avoid an overly broad interpretation of the standard to require discussion of matters that may not be directly connected to the audit.

Although the Board did not revise the requirement to list all the matters of which the auditor could inquire in this provision, the requirement in the standard is not meant to be limited only to matters that are related to violations or possible violations of laws. The Board did not consider it practical to revise the requirement in an attempt to list all the matters of which the auditor could inquire in this provision. Such matters can and should vary from audit to audit. Rather, the inclusion of such matters was meant to serve only as an example of a matter that the auditor should discuss with the audit committee.

The same commenter who objected to the breadth of the inquiry also raised concerns related to the audit committee providing information to the auditor about violations or possible violations of laws or regulations and complaints or concerns received regarding financial reporting matters contained in the repropose standard. The commenter indicated that the audit committee's communication of such information could cause the information to lose its confidentiality status with potential significant harmful consequences to the company, such as reducing the candor and chilling communications between management, employees, and the audit committee. The commenter also indicated that if the audit committee discloses information covered by privileged attorney-client communications or attorney work product to the auditor as part

of this communication, the company may face a risk that a court may later deem the company to have waived the protection of such privilege or work product doctrine.

The Board did not change the requirement to exclude inquiries regarding violations or possible violations of laws or regulations that are relevant to the audit. Limiting the scope of information that the audit committee might provide to the auditor could severely affect the auditor's ability to conduct an effective audit.

The purpose of this requirement is to enable the auditor to have the information necessary to conduct the audit to support the auditor's opinion on the company's financial statements. Due to the audit committee's oversight responsibilities, it is appropriate for the auditor to ask the audit committee for information relevant to the audit, including matters related to violations or possible violations of laws or regulations. Without such inquiry, the auditor may not have information that could influence the performance of the audit.

The same commenter also indicated that if the audit committee provides information relevant to the audit, the audit committee's role would change fundamentally from overseeing the accounting and financial reporting process of the company and audits of financial statements to becoming the original source of information for the auditor and guarantor of the accuracy and completeness of the financial statements, a role that historically has been that of management. It is possible, that in some situations, the communication from the audit committee is the first instance in which a matter is brought to the attention of the auditor. For example, in some situations the audit committee may have unique insight into management's performance. By providing the opportunity for the audit committee to discuss information with the auditor, the standard enables the auditor

to obtain the audit committee's perspective on matters which may be different from management's perspective.

**Overall Audit Strategy, Timing of the Audit, and Significant Risks (Paragraphs 9-11 of Auditing Standard No. 16)**

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit, and to discuss with the audit committee the significant risks<sup>63</sup> identified during the auditor's risk assessment procedures. Under this requirement, the auditor communicates to the audit committee the results of audit procedures performed in accordance with other PCAOB standards, such as Auditing Standard No. 9, *Audit Planning*, which requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. As part of the auditor's risk assessment process, the auditor is required to identify and assess the risk of material misstatement, including significant risks.<sup>64</sup>

The timing of communications related to the audit strategy may vary from audit to audit based on the facts and circumstances. However, early communication of these matters might enable the audit committee to understand the auditor's views regarding risk and thereby provide an opportunity for the audit committee to communicate insights regarding additional risks that the auditor did not identify and allow the auditor to more effectively incorporate the additional risks into the audit strategy.

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<sup>63</sup> See paragraph A5 of Auditing Standard No. 12, which defines significant risk as a risk of material misstatement that requires special audit consideration.

<sup>64</sup> See paragraphs 59, 70, and 71 of the Auditing Standard No. 12.

Some commenters indicated that the requirement for the auditor to communicate the audit strategy might result in the audit committee second guessing the auditor's strategy and the scope of the audit. These commenters suggested that the standard should emphasize that the auditor should not disclose details about the audit strategy that would allow management or the audit committee to take steps that could reduce the effectiveness of the audit strategy. Another commenter suggested the standard should require the auditor to provide specific details about the type and timing of procedures. Auditing Standard No. 16 includes a note, which indicates that the overview of the audit strategy is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures. Communicating certain details might reduce the effectiveness of those audit procedures. The Board considers that the language in Auditing Standard No. 16 strikes the appropriate balance; therefore, the standard was not revised.

Some commenters suggested that significant risks should be communicated throughout the audit rather than communicating just those significant risks identified during the auditor's risk assessment procedures. It is not the intent of the standard for the auditor to communicate only the significant risks that are identified during the auditor's risk assessment procedures. Paragraph 11 of Auditing Standard No. 16 requires the auditor to communicate significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

A commenter suggested that the communication of risks be expanded to include business risks and the auditor's views of the company's internal controls, in addition to the significant risks of material misstatement to the financial statements. As part of

obtaining an understanding of the company and its environment, Auditing Standard No. 12 requires the auditor to obtain an understanding of the company's objectives, strategies, and related business risks that could reasonably be expected to result in risks of material misstatement.<sup>65</sup> Under Auditing Standard No. 16, the auditor is required to communicate significant risks to the audit committee. If the auditor determines that a business risk results in a significant risk of material misstatement, the auditor should communicate the significant risk to the audit committee. Additionally, under Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, the auditor is required to communicate to the audit committee material weaknesses and significant deficiencies in internal control over financial reporting identified during the audit.<sup>66</sup> Therefore, the standard was not revised.

Auditing Standard No. 16 also requires communications regarding others involved in the audit, such as persons with specialized skill or knowledge, internal audit, and other firms or persons performing audit procedures. Communications of others involved in the audit might be important for an audit committee to understand as part of the audit committee's oversight of the financial reporting process.

#### **Specialized Skill or Knowledge (Paragraph 10.a. of Auditing Standard No. 16)**

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee the nature and extent of specialized skill or knowledge needed to

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<sup>65</sup> See paragraph 14 of Auditing Standard No. 12.

<sup>66</sup> See paragraphs 78 and 80 of Auditing Standard No. 5 and paragraph 4 of AU sec. 325.

perform the planned audit procedures or evaluate the audit results related to significant risks. This requirement is designed for the auditor to communicate the determination the auditor is required to make as part of developing the audit strategy in Auditing Standard No. 9.<sup>67</sup> Many audit firms have employees with specialized skill or knowledge that the engagement team can utilize. However, other firms might not have such in-house expertise. The focus of this requirement is on the communication about the need for specialized skill or knowledge, regardless of whether the specialist is from within the firm or outside the firm.

### **Internal Audit (Paragraphs 10.b. and 10.c. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements, including when internal audit provides direct assistance to the auditor. In addition, Auditing Standard No. 16 requires the auditor to communicate the extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting.

Auditing Standard No. 9 requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan, including the nature, timing, and extent of resources necessary to perform the

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<sup>67</sup> See paragraph 16 of Auditing Standard No. 9 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

engagement.<sup>68</sup> Other standards, including AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and Auditing Standard No. 5, provide additional requirements and impose limits on the use of internal audit staff. The requirement in Auditing Standard No. 16 is to communicate to the audit committee the extent to which the auditor plans to use the work of the company's internal auditors and others as determined in the audit plan.

**Other Firms or Persons Performing Audit Procedures (Paragraph 10.d. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit. The standard includes a note stating the term "other independent public accounting firms" includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

In planning and performing the audit, the auditor determines whether to use other auditors or other persons to perform audit procedures at individual client locations, business units, or to perform work related to specific audit areas or procedures. Those other auditors might be affiliated firms, non-affiliated firms, or other persons not employed by the auditor.

The note to Auditing Standard No. 16 was revised from the repropoed standard to clarify that the communication regarding other independent public accounting firms is

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<sup>68</sup> See paragraphs 8-9 of Auditing Standard No. 9.



not based on the type of relationship the auditor otherwise has with the other firms. Rather, the requirement for the auditor to communicate the names, locations, and planned responsibilities of other independent public accounting firms and other persons is to provide information to the audit committee regarding the parties involved in the audit. This requirement also might facilitate a discussion of how the work of other parties would affect the audit.

The repropoed standard also required the auditor to communicate to the audit committee the "planned roles" of others involved in the audit and the "scope of audit procedures." One commenter suggested that the requirement to communicate the "scope of audit procedures" should be clarified in the standard. Another commenter suggested that the communication should be expanded to be more robust when other participants are used to audit foreign components of a company. Auditing Standard No. 10, *Supervision of the Audit Engagement*, requires the auditor to inform engagement team members of their responsibilities<sup>69</sup> and AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, discusses situations in which the auditor uses the work and reports of other independent auditors who have audited financial statements of one or more subsidiaries, divisions, branches, components or investments included in the financial statements.<sup>70</sup> To align with these requirements, the standard was revised to require the auditor to communicate only the "planned responsibilities" of other participants involved in the audit, the requirements to communicate the "planned roles" of others involved in

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<sup>69</sup> See paragraph 5.a. of Auditing Standard No. 10.

<sup>70</sup> See AU sec. 543.01.

the audit and the "scope of audit procedures" were removed from the standard, and the standard was not expanded to include other considerations.

Many commenters suggested that the standard provide a threshold for determining when to make communications regarding others involved in the audit, such as when another auditor performs procedures related to a percentage of the company's total assets or addresses significant risks. Others suggested that the communication include only non-affiliated accounting firms. The standard was not revised because audit committees have oversight of the entire audit engagement, which includes work performed by other auditors. The audit committee should be aware of all the participants in the audit. This communication regarding other participants in the audit would enable the audit committee to inquire or otherwise determine, for example, whether the other participants are registered with the Board and are subject to PCAOB inspections and whether they have disciplinary history with the Board or other regulators.

This communication requirement is intended to be scalable. For example, the amount of detail the auditor generally would communicate to the audit committee regarding the participation of other auditors would be greater for participants that perform a significant portion of the audit or that perform procedures related to significant risks.

**Principal Auditor (Paragraph 10.e. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors. This communication requirement is based on the auditor's determination that the auditor can serve as the principal auditor in accordance with AU sec. 543. This communication

would enable the audit committee to evaluate the extent of work performed by the principal auditor in relation to work performed by other auditors.

The repropoed standard included a note to describe situations where such communications would be required. The Board determined that this note was not necessary because AU sec. 543, governs the determination of whether the auditor can serve as the principal auditor.

**Accounting Policies and Practices, Estimates, and Significant Unusual Transactions (Paragraph 12 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to the company's accounting policies and practices, estimates, and significant unusual transactions. However, the standard recognizes that management also might make communications to the audit committee regarding these matters and that the auditor might not need to communicate the information at the same level of detail as management as long as the auditor meets certain criteria specified in the standard. In such circumstances, the auditor should communicate any omitted or inadequately described matters to the audit committee.

**Accounting Policies and Practices (Paragraphs 12.a. and 12.b. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain information regarding the company's significant accounting policies and practices and also critical accounting policies and practices.

The standard uses the terms "significant accounting policies and practices" and "critical accounting policies and practices." The Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") and the International Accounting

Standards Board, require that companies disclose a description of all significant accounting policies as an integral part of the financial statements.<sup>71</sup> For example, the FASB ASC recognizes that an entity's description of its significant accounting policies is an integral part of the financial statements.<sup>72</sup> Additionally, the term "significant accounting policies and practices" is consistent with the term used in AU sec. 380 and understood in practice and, therefore, has not been separately defined.

The definition of "critical accounting policies and practices" in Auditing Standard No. 16 is based on the SEC's description of the term "critical accounting policies and practices" as a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results 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.<sup>73</sup> The selection of significant accounting policies and practices involves a broader range of transactions and events over time, while the selection of critical accounting policies and practices is tailored to specific events in the current year. Therefore, critical accounting

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<sup>71</sup> See FASB ASC, Topic 235, Notes to Financial Statements, section 235-10-50. As part of this disclosure, the entity is required to disclose accounting policies and to describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. Additionally, see paragraph 117 of International Accounting Standard 1, *Presentation of Financial Statements*, which requires the entity to disclose the summary of significant accounting policies, including the measurement basis used in preparing the financial statements and other accounting policies that are relevant to understanding the financial statements.

<sup>72</sup> See FASB ASC paragraphs 235-10-50-1 through 235-10-50-6.

<sup>73</sup> See SEC, Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183 (Jan. 28, 2003).

policies and practices might be viewed as a subset of significant accounting policies and practices.

**Significant Accounting Policies and Practices (Paragraph 12.a. of Auditing Standard No. 16)**

Auditing Standard No. 16 generally retains the requirements from AU sec. 380 related to communication of the company's significant accounting policies and practices, including:

- 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 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 in practice.

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to significant accounting policies and practices, whereas, AU sec. 380 required the auditor only to determine that the audit committee was "informed." This change in wording is intended to indicate that the auditor should make these communications, rather than determine that the audit committee was informed, as required in AU sec. 380. However, the note to paragraph 12 of Auditing Standard No. 16 acknowledges that such communications may be made by management, and if the auditor meets certain conditions, these communications need not be duplicated by the auditor.

Some commenters suggested that it was unclear whether the communication of the initial selection of, or changes in, significant accounting policies or the application of such policies in the current period would require communication annually if there is no

change. Another commenter indicated that the auditor may not be in a position to provide information on areas for which there is diversity in practice because the auditor may not be knowledgeable of accounting practices used by other entities.

Auditing Standard No. 16 was not revised in response to these comments. The standard indicates that the auditor should communicate to the audit committee the initial selection in the current period of significant accounting policies. The standard also indicates that the auditor should communicate to the audit committee changes in those policies or changes in the application of those policies in the current period if they differ from those policies that management previously utilized or how they were previously applied.

Additionally, the auditor's responsibility to communicate the effect of significant accounting policies includes (i) controversial areas or (ii) areas for which there is lack of authoritative guidance or consensus, or diversity in practice. The auditor should be aware of diversity in practice related to significant accounting policies and practices used by the company because Auditing Standard No. 12 requires the auditor to evaluate whether the company's selection of and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry.<sup>74</sup> Based on this evaluation, the auditor should be in a position to make such communication.

**Critical Accounting Policies and Practices (Paragraph 12.b. of Auditing Standard No. 16)**

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<sup>74</sup> Paragraph 12 of Auditing Standard No. 12.

Auditing Standard No. 16 incorporates the Exchange Act requirement for the auditor to communicate to the audit committee all critical accounting policies and practices to be used.<sup>75</sup> Auditing Standard No. 16 also requires the auditor 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.<sup>76</sup>

Some commenters recommended deleting the requirement for the auditor to communicate how anticipated future events might affect the determination of whether certain policies and practices are considered critical since the auditor cannot predict the future. The standard retains the SEC requirement regarding communication of anticipated future events related to critical accounting policies and practices, as this is a component of the required communication the SEC identified in adopting SEC Rule 2-07.<sup>77</sup> The standard notes that critical accounting policies and practices are tailored to specific events in the current year and that the accounting policies and practices that are considered critical might change from year to year. For example, a significant merger or acquisition may result in the related accounting policy being considered critical in the current year in which the related transaction occurs, but not in subsequent years. Auditing Standard No. 16 is aligned with the SEC requirement, therefore the standard was not revised.

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<sup>75</sup> Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), requires the auditor to report this information to the audit committee. *See also* SEC Rule 2-07 of Regulation S-X ("SEC Rule 2-07"), 17 C.F.R. § 210.2-07.

<sup>76</sup> *See* Securities Act Release No. 8183, which describes the SEC's expectations regarding the discussion related to critical accounting policies and practices. In this release, the SEC indicated that it anticipated that the discussion of accounting policies and practices would include how current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

<sup>77</sup> *Id.*

### **Critical Accounting Estimates (Paragraph 12.c. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate the following matters related to critical accounting estimates:

- (1) A description of the process management used to develop critical accounting estimates;
- (2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and
- (3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.

As the term "critical accounting estimate" implies, the communication is not designed to encompass a long list of accounting estimates resulting from the application of accounting policies that cover a substantial number of line items in the company's financial statements. Rather, Auditing Standard No. 16 defines the term "critical accounting estimate" as an accounting 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.

The definition of "critical accounting estimate" is based on SEC interpretive guidance in connection with management's discussion and analysis ("MD&A") of the



company's financial condition and results of operations.<sup>78</sup> The alignment of the term critical accounting estimates in PCAOB standards with the same term in the SEC's interpretive guidance allows auditors to use the same concept under SEC requirements and PCAOB standards when communicating matters to the audit committee. The term critical accounting estimate is used to help focus the communication to the audit committee on those estimates that might be subject to a higher risk of material misstatement, such as certain fair value estimates. The definition of a critical accounting estimate is intended to replace the term "particularly sensitive" in AU sec. 380.<sup>79</sup>

The requirement to communicate the process management used to develop critical accounting estimates is adapted from the requirement in AU sec. 380 related to particularly sensitive accounting estimates.<sup>80</sup> Additionally, the communication requirements are designed to communicate the results of the auditor's performance requirements under AU sec. 342, *Auditing Accounting Estimates*, which requires the auditor to evaluate the reasonableness of accounting estimates. In evaluating the reasonableness of the accounting estimate, AU sec. 342 also requires the auditor to obtain an understanding of how management developed the estimate.<sup>81</sup> AU sec. 342 also states

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<sup>78</sup> See SEC, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 8350 (Dec. 19, 2003).

<sup>79</sup> See AU sec. 380.08, which stated in part, "[c]ertain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments."

<sup>80</sup> AU sec. 380.08.

<sup>81</sup> See AU sec. 342.10.

that in evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are (a) significant to the accounting estimate, (b) sensitive to variations, (c) deviations from historical patterns, and (d) subjective and susceptible to misstatement and bias.<sup>82</sup>

One commenter suggested that the communication requirement also include how management subsequently monitors critical accounting estimates and, 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. Although these requirements are not included in Auditing Standard No. 16, the Board notes that the SEC has stated that management should disclose the company's critical accounting estimates in MD&A.<sup>83</sup> According to the related SEC release, management's discussion should present, among other matters, the company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time and analyze an estimate's specific sensitivity to change based on other outcomes that are reasonably likely to occur and would have a material effect.<sup>84</sup> The commenter's concerns, therefore, may be addressed through a company's MD&A disclosures.

AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires the auditor to read the other information, such as MD&A in documents containing audited financial statements, and consider whether the information,

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<sup>82</sup> See AU Sec. 342.09.

<sup>83</sup> See Securities Act Release No. 8350.

<sup>84</sup> *Id.*

or the manner of its presentation, is materially inconsistent with information in the financial statements or is a material misstatement of fact.<sup>85</sup> Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee the results of such procedures. Accordingly, no change was made to the standard.

**Significant Unusual Transactions (Paragraph 12.d. of Auditing Standard No. 16)**

Auditing Standard No. 16 includes requirements for the auditor to communicate to the audit committee (1) 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;<sup>86</sup> and (2) the policies and practices management used to account for significant unusual transactions. Communication of significant unusual transactions would enable the audit committee to gain the auditor's insight into those transactions and to take any appropriate action.

The requirement in the standard for the auditor to communicate the policies and practices management used to account for significant unusual transactions is similar to the requirement in AU sec. 380.<sup>87</sup> Under Auditing Standard No. 16, such communication also would include the identification of significant unusual transactions.

The repropoed standard required the auditor to communicate significant unusual transactions, of which the auditor is aware, that are outside the normal course of business for the company or otherwise appear to be unusual due to their timing, size, or nature. Many commenters indicated that management also might communicate matters related to

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<sup>85</sup> AU secs. 550.04-.05.

<sup>86</sup> See paragraph 71.g. of Auditing Standard No. 12.

<sup>87</sup> AU sec. 380.07.

significant unusual transactions to the audit committee and that the standard should acknowledge that management might make the communications related to significant unusual transactions. The standard was revised to recognize that management might make these communications to the audit committee and that, in those situations, the auditor might not need to communicate the information at the same level of detail as management as long as certain criteria specified in the standard are met. However, the auditor should communicate any omitted or inadequately described matters to the audit committee.

Additionally, some commenters suggested that the communication should be limited to significant unusual transactions that are considered significant risks. While a significant unusual transaction might also be considered a significant risk, this communication provides the audit committee with additional information regarding the significant unusual transactions and the policies and practices management used to account for such transactions, even if such transactions do not constitute significant risks. Significant unusual transactions, at times, have been considered to be a contributing factor in attempts to mislead investors about a company's financial condition. Therefore, providing the audit committee with information regarding significant unusual transactions could benefit the audit committee in its oversight of the financial reporting process.

Some commenters suggested that the standard include a definition of the term "significant unusual transactions." Auditing Standard No. 16 describes significant unusual transactions as 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, which is consistent with the description of this term in other PCAOB standards, such as Auditing Standard No. 12.<sup>88</sup> Therefore, the standard was not revised to further define significant unusual transactions.

**Consideration of Communications Made by Management (Note to Paragraph 12 of Auditing Standard No. 16)**

Auditing Standard No. 16 retains the substance of the communication requirements in AU sec. 380 regarding accounting policies, practices, and estimates. The requirement in the standard for the auditor to communicate critical accounting policies and practices is consistent with Section 10A(k) of the Exchange Act, which requires auditors of issuers to report all critical accounting policies and practices to the issuer's audit committee.<sup>89</sup> In addition, Auditing Standard No. 16 includes a new requirement related to the communication of significant unusual transactions.

Many commenters suggested that the standard should recognize that management has the primary responsibility for reporting to the audit committee and that the auditor's responsibility should be to confirm that management has appropriately communicated. No change was made in response to this comment because, similar to AU sec. 380, Auditing Standard No. 16 acknowledges that management also may be communicating certain matters related to the financial reporting process to the audit committee. The Board recognizes that management as well as the auditor might discuss accounting policies, practices, estimates, and significant unusual transactions with the audit committee and that it would not be cost-effective or practical for the audit committee to listen to essentially the same presentation twice. Therefore, Auditing Standard No. 16

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<sup>88</sup> Paragraph 71.g. of Auditing Standard No. 12.

<sup>89</sup> *See also* SEC Rule 2-07.

indicates that, in situations in which management communicates matters in paragraph 12, the auditor's communication requirement under the standard would be met if the auditor: (1) participates in management's discussion with the audit committee,<sup>90</sup> (2) affirmatively confirms to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identifies for the audit committee those accounting policies and practices that the auditor considers critical. In addition, the auditor should communicate any omitted or inadequately described matters to the audit committee.

In situations in which management makes those communications to the audit committee, in order to satisfy the communication requirement in Auditing Standard No. 16, the auditor would be required to participate during discussions between management and the audit committee regarding accounting policies, practices, estimates, and significant unusual transactions, which may include discussions of the importance of critical accounting policies, practices or estimates, or the difficult, subjective, or complex nature of the judgment involved in significant unusual transactions, or the selection or application of accounting policies, practices, or estimates. If the auditor identifies the accounting policies and practices that the auditor considers critical to the portrayal of the company's financial condition and results and affirmatively confirms that management has adequately communicated the accounting policies, practices, estimates, and significant unusual transactions to the audit committee in a meeting in which the auditor participated the auditor would be deemed to satisfy the requirement for the auditor to

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<sup>90</sup> The auditor's participation in management's discussion with the audit committee could be satisfied in person or via audio or video conference.

report all critical accounting policies and practices to the audit committee, without the need for the auditor to repeat management's presentation on the same topic.

Conversely, if the auditor (1) did not participate in management's meeting with the audit committee in which communication regarding accounting policies, practices, estimates, and significant unusual transactions occurred, (2) did not affirmatively confirm that accounting policies, practices, estimates, and significant unusual transactions had been discussed adequately by management, or (3) with respect to critical accounting policies and practices, did not identify those accounting policies and practices that the auditor considers critical, then the auditor would be required to communicate to the audit committee the matters described in paragraph 12 of Auditing Standard No. 16, regardless of any management communication regarding those matters.

**Auditor's Evaluation of the Quality of the Company's Financial Reporting  
(Paragraph 13 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate certain matters to the audit committee regarding the auditor's views of the audit and the financial statements as described below.

**Qualitative Aspects of Significant Accounting Policies and Practices (Paragraph 13.a. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate the results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements. This requirement is similar to certain communication requirements that have been superseded. AU sec. 380 required the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the

company's accounting principles.<sup>91</sup> Additionally, AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*, required the auditor to consider whether matters related to management bias should be communicated to the audit committee.<sup>92</sup>

The requirement in Auditing Standard No. 16 is designed for the auditor to communicate the results of the auditor's procedures under Auditing Standard No. 14, *Evaluating Audit Results*, which requires the auditor to, among other things, evaluate the qualitative aspects of the company's accounting practices,<sup>93</sup> including potential bias in management's judgments about the amounts and disclosures in the financial statements.<sup>94</sup>

Additionally, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the results of the auditor's evaluation of the differences between (i) estimates best supported by audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management. This communication is designed for the auditor to discuss the results of the auditor's evaluation of these matters as required under Auditing Standard No. 14.<sup>95</sup> Linking the communication requirements with performance

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<sup>91</sup> AU sec. 380.11.

<sup>92</sup> Following the original proposal of this standard, AU sec. 9312 was superseded when the Board adopted the risk assessment standards. The performance requirement of AU sec. 9312, however, was substantially included in the risk assessment standards.

<sup>93</sup> See paragraphs 24-27 of Auditing Standard No. 14.

<sup>94</sup> *Id.*

<sup>95</sup> See paragraph 27 of Auditing Standard No. 14.



requirements in Auditing Standard No. 14 provides context regarding the matters to be communicated.

Some commenters suggested that the standard should retain the requirement in AU sec. 380 for the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles.

Auditing Standard No. 16 modifies the requirement from AU sec. 380 by requiring the auditor to communicate to the audit committee the results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, while linking the communication requirement to the performance requirement in Auditing Standard No. 14. Therefore, no change was made in response to these comments.

**Assessment of Critical Accounting Policies and Practices (Paragraph 13.b. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosures of those policies and practices proposed by the auditor that management did not make. This requirement is based on the Exchange Act's requirement that the auditor report to the audit committee all critical accounting policies and practices.<sup>96</sup> In the release adopting the SEC's related rule, the SEC indicated that it anticipated that the auditor's communications to the audit committee regarding critical accounting policies would

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<sup>96</sup> See Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k); and SEC Rule 2-07.

include an assessment of management's disclosures along with any significant proposed modifications by the auditor that were not included in those disclosures.<sup>97</sup>

**Conclusions Regarding Critical Accounting Estimates (Paragraph 13.c. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate the basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates. This requirement is similar to a requirement in AU sec. 380.<sup>98</sup> This requirement is designed to require the auditor to communicate the results of the auditor's procedures regarding critical accounting estimates under PCAOB standards, such as AU sec. 342.<sup>99</sup> Communicating these results will provide the audit committee with the auditor's assessment of the critical accounting estimates based on the auditor's procedures.

**Significant Unusual Transactions (Paragraph 13.d. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's understanding of the business rationale for significant unusual transactions. This communication requirement is aligned with the performance requirement in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, which requires the auditor to gain an understanding of the business rationale regarding significant transactions that are outside the normal course of business or that otherwise appear unusual.<sup>100</sup> This communication would provide the audit committee with an opportunity to receive the auditor's perspective of such transactions.

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<sup>97</sup> See Securities Act Release No. 8183.

<sup>98</sup> See AU sec. 380.08.

<sup>99</sup> See AU secs. 342.04, 09-.10.

<sup>100</sup> See AU sec. 316.66.

In a separate rulemaking project, the Board has proposed amendments to AU sec. 316 that would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or lack thereof) of each significant unusual transaction and evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.<sup>101</sup> If, at the conclusion of that rulemaking project, the Board adopts the proposed amendments to AU sec. 316, the Board will consider, as appropriate, amending Auditing Standard No. 16 to align the communication with any new performance requirements.

**Financial Statement Presentation (Paragraph 13.e. of Auditing of Auditing Standard No. 16)**

Similar to AU sec. 380.11, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth. This communication requirement relates to the auditor's evaluation of whether the financial statements are

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<sup>101</sup> *Proposed Auditing Standard - Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012).

presented fairly, in all material respects, in conformity with the applicable financial reporting framework, as required by Auditing Standard No. 14.<sup>102</sup>

Some commenters suggested that the standard should retain the requirement in AU sec. 380 for the auditor to discuss with the audit committee the auditor's views about the clarity and completeness of the company's financial statements and disclosures. However, commenters on the original proposed standard indicated it was not clear what was meant by the clarity and completeness of the company's financial statements and related disclosures. Commenters also expressed concern as to what should be included in the communications to the audit committee. The communication requirement in Auditing Standard No. 16 avoids possible confusion regarding the meaning of the phrase "clarity and completeness" by linking it to the auditor performance requirements included in Auditing Standard No. 14 for the auditor to evaluate the presentation of the financial statements, including disclosures. The performance requirements in Auditing Standard No. 14<sup>103</sup> provide context regarding the matters to be communicated under Auditing Standard No. 16.

#### **New Accounting Pronouncements (Paragraph 13.f. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a

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<sup>102</sup> See paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibility relating to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

<sup>103</sup> *Id.*

significant effect on future financial reporting. This requirement is based on the situations in which, as a result of the auditor's procedures, the auditor has identified a concern regarding the anticipated application of a new accounting pronouncement. Auditing Standard No. 16 does not require the auditor to perform additional procedures to identify such concerns.

Some commenters noted that management generally discloses in the financial statements the potential effects of adoption of new accounting standards and that this auditor communication to the audit committee should be related to the auditor's evaluation of management's disclosures related to new accounting pronouncements. The intent of the required communication to the audit committee is not meant to provide an additional evaluation of management's disclosures. Rather, the intent is to inform the audit committee when the auditor "has identified a concern" regarding the planned implementation of a new accounting pronouncement or whether management has devoted adequate resources to prepare its accounting and disclosure processes, and other financial reporting systems, for the timely implementation of the new accounting pronouncement. This communication might inform the audit committee's oversight of the company's financial reporting process. Requiring the discussion of such matters is intended to allow the audit committee to properly consider the auditor's concerns regarding future financial statements. Accordingly, no change to the standard was made.

**Alternative Accounting Treatments (Paragraph 13.g. of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate all alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management,

including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor. This requirement is consistent with Section 10A(k) of the Exchange Act and with SEC Rule 2-07, which requires the auditor to report to the audit committee all alternative treatments that are related to material items, were discussed with management, and are permissible under the applicable financial reporting framework.<sup>104</sup>

**Other Information in Documents Containing Audited Financial Statements  
(Paragraph 14 of Auditing Standard No. 16)**

Auditing Standard No. 16 retains the requirement from AU sec. 380.12 for the auditor to communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for other information presented in documents containing audited financial statements, any related procedures performed, and the results of such procedures. Such other information would include documents described in AU sec. 550, AU sec. 558, *Required Supplementary Information*, and AU sec. 711, *Filings Under Federal Securities Statutes*.

The auditor's responsibility under AU sec. 550 requires the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, in the financial statements.<sup>105</sup> One commenter suggested that Auditing Standard No. 16 should also include a requirement to communicate any identified

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<sup>104</sup> See SEC Rule 2-07, Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), and Securities Act Release No. 8183.

<sup>105</sup> See generally, AU secs. 550.04-.07, which require that the auditor read the information and consider whether it is materially inconsistent with information in the financial statements or whether it contains any material misstatements of fact.

material inconsistencies or misstatements of facts, including the auditor's response to such matters.

Auditing Standard No. 16 requires the auditor to communicate the results of the auditor's procedures related to other information in documents containing audited financial statements, which would require the auditor to communicate identified inconsistencies or misstatements of facts to the audit committee. The Board is amending AU sec. 550 to require the auditor to communicate to the audit committee the material inconsistency between the other information and the financial statements in situations in which the information is not revised to eliminate the material inconsistency. The Board also is amending AU sec. 550 to require the auditor to communicate to the client and the audit committee, in writing, a material misstatement of fact in the other information.

Thus, it was not necessary to revise the standard in response to commenters.

**Difficult or Contentious Matters for which the Auditor Consulted (Paragraph 15 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process. The required communications of difficult or contentious matters are based on the results of the procedures the auditor performed regarding such matters during the course of the audit and do not require the performance of new or additional procedures.

Many matters that arise during an audit can be complex or unusual, and the auditor might consult on such matters with the firm's national office, industry specialists, or external parties. Difficult or contentious issues can arise in various stages of the audit,

including in the auditor's evaluation of management's judgments, estimates, accounting policies, or assessment of identified control deficiencies. Difficult or contentious issues generally are the critical matters that concern the auditor when he or she is making the final assessment of whether the financial statements are presented fairly.

A difficult issue might not always be synonymous with a contentious issue. Rather, a difficult issue might be a matter that requires consultation. A contentious issue might be a matter that not only requires consultation but also leads to significant points of disagreement, debate, or deliberation between the auditor and management. Audit committees might better appreciate the importance of difficult or contentious matters if they are aware that such consultations took place.

During the course of the audit difficult or contentious issues might arise for which the auditor did not consult, but which the auditor believes are relevant to the audit committee's oversight of the financial reporting process. Auditing Standard No. 16 does not preclude the auditor from communicating to the audit committee difficult or contentious matters for which the auditor did not consult outside the engagement team.

Some commenters suggested that the standard should define difficult or contentious matters. The term "difficult or contentious matter" is used in Auditing Standard No. 7, *Engagement Quality Review*. Therefore, the term "difficult or contentious matter" is not defined in this standard.

Some commenters suggested that the standard should exclude the discussions between the auditor and the engagement quality reviewer from communications to the audit committee regarding consultation outside the engagement team on difficult or contentious matters. The communication to the audit committee in Auditing Standard No.



16 focuses on the difficult or contentious matters on which the auditor consulted, not on the parties involved in the consultation. Therefore, the standard was not revised.

**Management Consultation with Other Accountants (Paragraph 16 of Auditing Standard No. 16)**

When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's views about such matters that were the subject of such consultation. This requirement is similar to a requirement in AU sec. 380.<sup>106</sup> Communicating matters that were the subject of consultations only when the auditor has identified a concern about those matters should allow the audit committee to focus its efforts on important accounting and auditing issues.

Some commenters suggested that communicating management consultations with other accountants should be management's responsibility and that the standard should clarify that the auditor should comment only on what management has communicated regarding such consultations. The standard does not impose a communication requirement on management. The requirement in Auditing Standard No. 16 is specifically related to the auditor's responsibilities when management has consulted with other accountants and only when the auditor has a concern regarding the accounting and auditing matters that were the subject of management's consultations. Therefore, Auditing Standard No. 16 was not revised.

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<sup>106</sup> AU sec. 380.14.

As part of the comment process, the Board asked whether the requirement to communicate about consultations should be expanded to include consultations on accounting or auditing matters with non-accountants, such as consulting firms or law firms. Some commenters suggested that communication regarding management's consultations with non-accountants should be required, while others suggested that communication about these consultations should be made at the auditor's discretion depending on the facts or circumstances and the significance of the consultation to the financial statements. However, many commenters indicated that this communication should not be expanded to include consultations with non-accountants, as the auditors would not be in position to know about all management consultations with non-accountants. Some commenters indicated that this requirement could result in the auditor expending significant effort to identify and evaluate management's consultations with non-accountants. After consideration of these comments, the standard was not revised to require the auditor to communicate management's consultation with non-accountants.

**Going Concern (Paragraph 17 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to the auditor's evaluation of the company's ability to continue as a going concern. The communication requirements in Auditing Standard No. 16 are based on the auditor's performance requirements under AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which requires the auditor to evaluate whether there is substantial doubt about the company's ability to

continue as a going concern for a reasonable period of time.<sup>107</sup> The auditor's communication to the audit committee regarding the auditor's evaluation of the company's ability to continue as a going concern can serve to further inform the audit committee, in certain circumstances, regarding difficult conditions and events that the company is encountering.

Auditing Standard No. 16 requires the auditor to communicate the conditions and events the auditor 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. Information about such conditions and events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions in the financial statements.<sup>108</sup> Examples of such conditions and events include, but are not limited to, negative trends, other indications of possible financial difficulties, internal matters, or external matters that have occurred.<sup>109</sup>

Under AU sec. 341, if after considering the identified conditions and events, in the aggregate, the auditor believes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should consider management's plans for dealing with the adverse effects of the conditions and

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<sup>107</sup> See AU sec. 341.06, which provides examples of such conditions and events and AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

<sup>108</sup> See AU sec. 341.02.

<sup>109</sup> See AU sec. 341.06, which provides examples of such conditions and events.

events.<sup>110</sup> Additionally, the auditor should obtain information about the plans and consider whether it is likely that the adverse effects will be mitigated for a reasonable period of time, and that such plans can be effectively implemented.<sup>111</sup> Auditing Standard No. 16 requires that if the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the auditor should communicate to the audit committee the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events.<sup>112</sup>

Under AU sec. 341, if the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph to reflect the auditor's conclusion that there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.<sup>113</sup> Additionally, Auditing Standard No. 16 requires that if the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains,<sup>114</sup> the auditor should

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<sup>110</sup> See AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

<sup>111</sup> See AU sec. 341.03b.

<sup>112</sup> See AU sec. 341.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

<sup>113</sup> See AU sec. 341.12.

<sup>114</sup> See AU sec. 341.03c, which discusses the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

communicate to the audit committee: (1) the effects, if any, on the financial statements and the adequacy of the related disclosure;<sup>115</sup> and (2) the effects on the auditor's report.<sup>116</sup>

The repropoed standard required the auditor to communicate the conditions and events the auditor identified that, when considered in the aggregate, indicate that there "could be" substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. Some commenters suggested that the threshold for communication to the audit committee should be when the auditor believes there "is" substantial doubt about the company's ability to continue as a going concern, rather than when there "could be" substantial doubt. Those commenters suggested that threshold because, under AU sec. 341, the auditor is required to consider management's plans for addressing the adverse effects of the events and conditions when the auditor believes there "is" substantial doubt.

Auditing Standard No. 16 was revised to require the threshold for the auditor's initial communication to the audit committee to be when the auditor "believes there is" substantial doubt about the company's ability to continue as a going concern. This aligns more closely the communication requirement about the conditions and events with the other communication requirements in paragraph 17 of Auditing Standard No. 16. Under paragraph 17 of Auditing Standard No. 16 the auditor is required to communicate

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<sup>115</sup> See AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

<sup>116</sup> See AU secs. 341.12-.16, which discuss the auditor's consideration of the effects on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

conditions and events, along with the auditor's conclusion regarding whether either management's plans alleviate the adverse effects of the conditions and events (item b) or substantial doubt remains (item c).

**Uncorrected and Corrected Misstatements (Paragraphs 18-19 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to provide the audit committee with the schedule of uncorrected misstatements<sup>117</sup> relating to accounts and disclosures that was presented to management. Several commenters indicated that audit committees would not find value in information presented at the same level of detail as presented to management, and that the auditor, therefore, should provide a summary of misstatements to the audit committee.

The Board decided to retain the requirement because presenting a schedule that shows only a summary of the uncorrected misstatements rather than the individual misstatements might not be informative for the audit committee. In addition, the requirement in Auditing Standard No. 16 is not a significant change from AU sec. 380.10, which required the presentation to the audit committee of a schedule of uncorrected misstatements.

The schedule of uncorrected misstatements required by Auditing Standard No. 16 is similar to the summary of uncorrected misstatements included in or attached to the management representation letter.<sup>118</sup> Additionally, the Exchange Act and SEC Rule 2-07 require the auditor to provide to the audit committee other material written

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<sup>117</sup> Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include both omissions and the presentation of inaccurate or incomplete disclosures.

<sup>118</sup> See paragraph .06g of AU sec. 333, *Management Representation*.

communications between the auditor and management, which would include the schedule of unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any.<sup>119</sup>

Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial, and to communicate those to management on a timely basis.<sup>120</sup> According to Auditing Standard No. 14, a misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework.<sup>121</sup> The requirement in Auditing Standard No. 16 to communicate misstatements related to accounts and disclosures relates only to those misstatements that the auditor has accumulated throughout the audit that are not clearly trivial and have been reported to management.

Auditing Standard No. 16 also requires the auditor to discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors<sup>122</sup> considered. In addition, the auditor also should communicate to the audit committee that uncorrected misstatements or matters

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<sup>119</sup> See Section 10A(k)(3) of the Exchange Act, 15 U.S.C. § 78j-1(k)(3), SEC Rule 2-07(a)(3) and Securities Act Release No. 8183.

<sup>120</sup> See paragraphs 10 and 15 of Auditing Standard No. 14.

<sup>121</sup> See paragraph A2 of Auditing Standard No. 14.

<sup>122</sup> See Appendix B of Auditing Standard No. 14, which discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

Auditing Standard No. 16 also requires the auditor to communicate those corrected misstatements, other than those that are clearly trivial, related to accounts and disclosures that might not have been detected except through the auditing procedures performed and discuss with the audit committee the implications that such corrected misstatements might have on the financial reporting process.

One commenter suggested that the standard should require the auditor to communicate management's adjusting entries recorded at the end of the period or other entries to reconcile accounts. The release accompanying the original proposed standard included a question that asked whether all corrected misstatements, including those detected by management, should be communicated to the audit committee. Many commenters responding to the question were not supportive of the auditor communicating misstatements detected by management or management's period-end adjusting entries, because the auditor may not have knowledge of all such adjustments due to the nature of a company's financial statement close process and the timing of the auditor's procedures. Commenters suggested that such a requirement would likely result in the auditor expending significant effort to identify misstatements or adjusting entries that the company's internal controls previously identified in the financial close process. Accordingly, the standard does not include a requirement for the auditor to communicate misstatements detected by management.



Some commenters suggested that the standard should be revised to require the auditor to communicate only corrected misstatements that individually or in the aggregate could be significant to the company's financial statements. As noted previously, Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. The misstatements the auditor accumulated and management corrected are those that are other than clearly trivial and could be significant to the company's financial statements, either quantitatively or qualitatively. Auditing Standard No. 16 also requires the auditor to communicate those corrected misstatements that might not have been detected except through the auditing procedures performed. The intent of this requirement is to inform the audit committee of misstatements, which might have certain implications on the company's financial reporting process, that were detected only through audit procedures. Therefore, Auditing Standard No. 16 was not revised.

Another commenter suggested that the standard should specifically require the auditor to request management to correct the uncorrected misstatements. The Board did not make this change because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements. Section 13(i) of the Exchange Act requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.<sup>123</sup>

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<sup>123</sup> Section 13(i) of the Exchange Act, 15 U.S.C. § 78j-1(m)(i).

### **Material Written Communication (Paragraph 20 of Auditing Standard No. 16)**

Auditing Standard No. 16 incorporates the Exchange Act's requirement for the auditor to communicate other material written communications between the auditor and management to the audit committee.<sup>124</sup> This requirement is intended to capture other possible material written communications that might occur but are not addressed by requirements in the standard or by other PCAOB standards, such as the management representation letter.<sup>125</sup>

### **Departure from the Auditor's Standard Report (Paragraph 21 of Auditing Standard No. 16)**

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee when the auditor expects to modify the opinion in the auditor's report or include explanatory language or an explanatory paragraph in the auditor's report.<sup>126</sup> The auditor is required to communicate the reasons for and the wording of the modification, explanatory language, or explanatory paragraph. The requirement is intended to provide the basis for a discussion between the auditor and the audit committee in those circumstances in which the auditor expects to add explanatory language or modify the opinion in the auditor's standard report.

As part of overseeing the audit and the financial reporting process, it might be important for the audit committee to understand the reasons an auditor adds explanatory

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<sup>124</sup> Section 10A(k)(3) of the Exchange Act, 15 U.S.C. § 78j-1(k)(3), requires the auditor to report this information to the audit committee; *see also* SEC Rule 2-07.

<sup>125</sup> *See* Securities Act Release No. 8183 for a discussion of the substance of other material written communications.

<sup>126</sup> *See* paragraphs .11-.74 and .76 of AU sec. 508, *Reports on Audited Financial Statements*.

language or modifies the opinion in the auditor's standard report. Such communication enables the audit committee to be aware of the nature of any specific matters that the auditor expects to highlight in the auditor's report. In addition, these communications provide the audit committee with an opportunity to obtain further clarification from the auditor about the modification. This communication also provides the audit committee with an opportunity to provide the auditor with further information and explanations regarding the matters that are expected to be included in the auditor's report.

**Disagreements with Management (Paragraph 22 of Auditing Standard No. 16)**

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee any 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 auditor's report. This requirement is retained from AU sec. 380.13.

Examples of disagreements might include disagreements with management about the application of accounting principles to the company's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements might also arise regarding the scope of the audit, disclosures to be made in the company's financial statements, or the wording of the auditor's report. For purposes of Auditing Standard No. 16, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional, relevant facts or information prior to the issuance of the auditor's report.

One commenter suggested that disagreements that are satisfactorily resolved should not be communicated to the audit committee unless the auditor determines that these matters warrant the audit committee's attention. As noted previously, this communication requirement is not new. As part of conducting the oversight of the audit and the financial reporting process, it might be important for the audit committee to know the areas of tension between the auditor and management regarding matters that could be significant to the company's financial statements, such as accounting principles and practices, financial statement disclosures, auditing scope or procedures, or similar matters. Accordingly, no change was made in response to this comment. Additionally, SEC Form 8-K requires that a registrant report certain disagreements between management and the auditor, whether or not such disagreements are satisfactorily resolved, when there is a change in the auditor.<sup>127</sup> The requirement in Auditing Standard No. 16 provides the audit committee with information regarding important matters that might need to be reported subsequently in an SEC filing.

**Difficulties Encountered in Performing the Audit (Paragraph 23 of Auditing Standard No. 16)**

Auditing Standard No. 16 includes the requirement from AU sec. 380.16 for the auditor to communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

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<sup>127</sup> See e.g., Exchange Act Form 8-K, Item 4.01. See also Item 304(a)(1)(iv) of Regulation S-K, 17 C.F.R. § 229.304(a)(1)(iv), and Instructions 4 and 5 to that item, which require disclosure of disagreements, or differences of opinion, at the "decision-making level," that, if not resolved to the auditor's satisfaction, would have caused the auditor to make reference to the subject matter of the disagreement in connection with his or her report.

- Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;
- An unreasonably brief time within which to complete the audit;
- Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;
- Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and
- Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

#### **Other Matters (Paragraph 24 of Auditing Standard No. 16)**

Auditing Standard No. 16 requires the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters. Communication of the other matters is based on the results of audit procedures or the conduct of the audit and does not require the auditor to perform new or additional procedures beyond the communication itself.

The Sarbanes-Oxley Act requires that audit committees of listed companies establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting control, or auditing matters, and

for the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.<sup>128</sup>

Auditing Standard No. 12 requires the auditor to inquire of the audit committee regarding tips or complaints received by the audit committee regarding financial reporting matters. The auditor might become aware of complaints or concerns regarding financial reporting matters that were not received through the audit committee's process, and, therefore, are unknown to the audit committee. The audit committee might be better able to exercise its oversight activities if the auditor informed the audit committee of these matters. Paragraph 24 of Auditing Standard No. 16 requires the auditor to communicate these matters to the audit committee.

AU sec. 380 required the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process. Auditing Standard No. 16 enhances the requirement in AU sec. 380 for the auditor to communicate to the audit committee the results of the audit procedures regarding the accounting or auditing matters that have been the subject of complaints or concerns.

The standard acknowledges that there might be other matters known to the auditor that may be beneficial to the audit committee's oversight of the financial reporting process. This communication could provide the audit committee with an opportunity to better understand management's intentions regarding such matters.

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<sup>128</sup> See Section 301 of the Sarbanes-Oxley Act, and Section 10A(m)(4) of the Exchange Act, 15 U.S.C. § 78j-1(m)(4).

Several commenters suggested that Auditing Standard No. 16 should require the auditor to communicate to the audit committee the results of PCAOB inspection findings and any necessary remediation by the audit firm. With respect to inspections, the Sarbanes-Oxley Act restricts what the Board may publicly disclose,<sup>129</sup> and the Sarbanes-Oxley Act makes no exception for disclosure to an audit committee even if a Board inspection has reviewed an audit of the financial statements overseen by that audit committee. The Board cannot compel a firm to disclose nonpublic inspection information to an audit committee. This need not prevent an audit committee from discussing inspection results with its auditor. The Board encourages firms to communicate effectively with audit committees about inspection matters. The Sarbanes-Oxley Act does not restrict a firm from disclosing to an audit committee nonpublic information regarding PCAOB inspections (including quality control deficiencies and the firm's remediation of those deficiencies) or PCAOB disciplinary matters.<sup>130</sup>

**Form and Documentation of Communications (Paragraph 25 of Auditing Standard No. 16)**

Auditing Standard No. 16 retains from AU sec. 380 the ability for auditors to communicate to the audit committee either orally or in writing, unless otherwise specified in the standard. Some commenters suggested that the standard should require all communications to be in writing, while other commenters indicated that the standard should continue to provide flexibility in the manner of communication.

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<sup>129</sup> See Section 104(g)(2) of the Sarbanes-Oxley Act (providing that the Board shall make inspection reports available to the public in appropriate detail "subject to," among other things, the broad disclosure restrictions of Section 105(b)(5)(A)).

<sup>130</sup> See *Information for Audit Committees About the PCAOB Inspection Process*, PCAOB Release No. 2012-003 (Aug. 1, 2012).

Auditing Standard No. 16 was not revised to require all communications to be in writing. The Board's intention is to promote effective two-way communication between the auditor and the audit committee, whether through presentations, written reports, or interactive discussions. Written communications might provide the auditor with a basis to lead an active two-way discussion with the audit committee.

In addition, the form of communication may depend on the nature of the matter to be communicated. For example, written information often makes it easier for the audit committee to understand highly complex information (for example, information about critical accounting estimates). However, having a dialogue on key matters often is an important factor in effective communications between the auditor and the audit committee.

Auditing Standard No. 16 also requires the auditor to document the communications in the work papers, whether such communication took place orally or in writing. The standard further requires the auditor to include a copy of or a summary of management's communications provided to the audit committee in the audit documentation if, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs 12 or 18 and, as a result, the auditor did not communicate these matters at the same level of detail as management.

**Timing (Paragraph 26 of Auditing Standard No. 16)**

The Board considers communications with audit committees to be an integral part of the audit process. AU sec. 380 stated that audit committee communications are incidental to the audit and are not required to occur before the issuance of the auditor's



report on the entity's financial statements so long as the communications occur on a timely basis.<sup>131</sup> Auditing Standard No. 16 requires the auditor to communicate the matters required by the standard in a timely manner and prior to the issuance of the auditor's report. This requirement aligns the timing of communications with SEC Rule 2-07, which requires the auditor to communicate matters to the audit committee prior to the filing of the auditor's report with the SEC.<sup>132</sup> The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up actions needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

The reproposed standard specified that all communications be made in a timely manner and prior to the issuance of the auditor's report, unless other timing requirements are specified by PCAOB rules or standards or the rules or regulations of the SEC. One commenter suggested that the "rules and regulations of the SEC" should be modified to the "federal securities laws," since timing of certain communications to the audit committee also is specified in securities laws. The standard was updated to reference "securities laws."<sup>133</sup>

Commenters generally agreed that audit committee communications should occur in a timely manner and prior to the issuance of the auditor's report. Some commenters

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<sup>131</sup> AU sec. 380.04.

<sup>132</sup> See SEC Rule 2-07.

<sup>133</sup> The term "securities laws" is defined in section 2(a)(15) of the Sarbanes-Oxley Act, 15 U.S.C. § 7201, to mean the provisions of law referred to section 3(a)(47) of the Exchange Act, 15 U.S.C. § 78c(a)(47), as amended by the Sarbanes-Oxley Act, and includes the rules, regulations, and orders issued by the SEC thereunder.

suggested that the standard should specify the timing of the communication about certain matters, such as during planning or prior to the earnings release.

Auditing Standard No. 16 does not emphasize the specific timing of certain communications because the appropriate timing might vary depending on the circumstances. As noted in the standard, the appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and any corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws. However, in all events, the timing of the communication should be prior to the issuance of the auditor's report.

Providing communications required by Auditing Standard No. 16 to the audit committee in a timely manner and prior to the issuance of the auditor's report will allow the audit committee and the auditor the opportunity to take any action they may deem appropriate to address the matters communicated prior to the issuance of the auditor's report.

The reproposed standard noted that an auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit; however, the auditor should communicate such matters to the full audit committee prior to the issuance of the auditor's report. Several commenters suggested that the auditor's responsibility to subsequently communicate to the "full" audit committee was an unnecessary burden and that the word "full" should be deleted to allow the auditor to communicate to the audit committee when a quorum is present. The standard was revised accordingly to eliminate the word "full."

## **Adequacy of the Two-Way Communication Process**

The original proposed standard included a requirement for the auditor to evaluate whether the two-way communication between the auditor and the audit committee was adequate to support the objectives of the audit. The requirement was included to emphasize that effective two-way communication is beneficial to achieving the objectives of the audit.

Many commenters on the original proposed standard noted that an evaluation of the adequacy of the two-way communications can only be effective if both parties are involved in the evaluation. These commenters also suggested that if only the auditor evaluates the effectiveness based on his or her understanding of what was communicated, that evaluation would not provide information about the audit committee's understanding of that communication. In response to commenters, the Board removed this requirement in the repropoed standard.

Some commenters on the repropoed standard indicated that the Board should reinstate the requirement for the auditor to evaluate the adequacy of the two-way communication between the auditor and the audit committee to encourage the auditor to determine whether there is effective two-way communication. Additionally, some commenters suggested that the standard should be revised to change certain requirements for the auditor to communicate "with" the audit committee instead of "to" the audit committee in situations in which two-way discussion would be appropriate for the auditor to obtain information on particular matters relevant to the audit.

The note in paragraph 3 of Auditing Standard No. 16 states that the requirement for the auditor to "communicate to" the audit committee is meant to encourage effective

two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit. The importance of effective two-way communications remains in the standard; therefore, no change was considered necessary.

In addition, as part of understanding the company's control environment in Auditing Standard No. 12, the auditor assesses whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.<sup>134</sup> Other PCAOB standards require that, in an audit of financial statements, if the auditor becomes aware, or in an integrated audit, if the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.<sup>135</sup> Not including a requirement for the auditor to evaluate the adequacy of a two-way communication in this standard does not change the auditor's responsibility for assessing the audit committee's effectiveness under existing PCAOB standards.

### **Amendments to PCAOB Standards**

With the adoption of Auditing Standard No. 16, the Board adopted related communication requirements to other PCAOB standards. These amendments were made to the following standards, among others:

- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*;

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<sup>134</sup> See paragraphs 23-24 of Auditing Standard No. 12.

<sup>135</sup> See paragraph 79 of Auditing Standard No. 5 and paragraph 5 of AU sec.

- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*;
- AU sec. 317, *Illegal Acts by Clients*;
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*; and
- AU sec. 722, *Interim Financial Information*.

The Board is amending AU sec. 722 to be consistent with Auditing Standard No. 16. Some commenters suggested that the amendments to AU sec. 722 should clarify that the accountant ("accountant" is the term used in AU sec. 722) is not required to repeat communications that were made as part of the annual audit. Other commenters suggested that the amendments to AU sec. 722 should become effective for interim periods following the first annual period in which Auditing Standard No. 16 becomes effective and that, otherwise, implementing the amendments prior to the first annual communication under Auditing Standard No. 16 would likely result in unnecessarily expanding the communication requirements related to the auditor's review of interim information.

The objective of a review of interim financial information pursuant to AU sec. 722 is to provide the accountant with a basis for communicating whether the accountant is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.<sup>136</sup> Procedures for conducting a review of interim financial information generally are limited to analytical procedures, inquiries, and other procedures that address significant

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<sup>136</sup> AU sec. 722.07.

accounting and disclosure matters relating to the interim financial information to be reported.<sup>137</sup> A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be identified in an audit.<sup>138</sup>

AU sec. 722.18 requires the accountant to make inquiries of members of management who have responsibility for financial and accounting matters, including but not limited to, matters concerning unusual or complex situations that may have an effect on the interim financial information. Examples of situations about which the accountant would ordinarily inquire of management include, among other things, significant, unusual, or infrequently occurring transactions; application of new accounting principles; changes in accounting principles or the methods of applying them; and trends and developments affecting accounting estimates.<sup>139</sup>

An amendment to AU sec. 722 states that when conducting a review of interim financial information, the accountant also should determine whether any of the matters described in Auditing Standard No. 16, as they relate to interim financial information, have been identified.<sup>140</sup> This requirement is similar to the current requirement for the accountant to refer to AU sec. 380 for matters to communicate to the audit committee when conducting an interim review.<sup>141</sup>

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<sup>137</sup> AU sec. 722.15.

<sup>138</sup> AU sec. 722.07.

<sup>139</sup> AU sec. 722.55.

<sup>140</sup> Amendment to AU sec. 722.34.

<sup>141</sup> *Id.*

Additionally, the amendments to AU sec. 722 recognize that management might communicate some or all of the matters related to the company's accounting policies, practices, estimates, and significant unusual transactions described in paragraph 12 of Auditing Standard No. 16. If management communicates any of these matters, the accountant does not need to communicate them at the same level of detail as management, as long as certain criteria are met. However, any omitted or inadequately described matters should be communicated to the audit committee.

The amendment to AU sec. 722.35 also indicates that any communication the accountant may make about the entity's accounting policies, practices, estimates, and significant unusual transactions as applied to its interim financial reporting generally would be limited to the effect of significant events, transactions, and changes in accounting estimates that the accountant considered when conducting the review of interim financial information. The amendments to AU sec. 722 do not require that the communications to the audit committee repeat the annual communications but, rather, that the communication be related to the accountant's findings while performing the interim review procedures.

The Board determined not to defer the effective date for quarterly reviews as suggested by some commenters. Deferral of the effective date would result in AU sec. 380 continuing to apply to communications relevant to quarterly reviews, while Auditing Standard No. 16 simultaneously would require communications relating to the annual audit. Auditing Standard No. 16 requires timely communications of matters in connection with the annual audit to be made throughout the year under audit. These communications would, therefore, be made at or near the time that related communications are required in

connection with quarterly reviews. Applying Auditing Standard No. 16 for the annual audit and AU sec. 380 for quarterly reviews could cause some degree of complexity because auditors would be required to apply two different standards when communicating important information to the audit committee. Therefore, the Board is making Auditing Standard No. 16 effective for quarterly reviews of fiscal years beginning on or after December 15, 2012.

In addition to avoiding having two co-existing and differing standards, implementing Auditing Standard No. 16 in the first quarter of 2013 should benefit audit committees by providing for the communication of significant information during the most current period. Also, and as discussed above, the objective of a review of interim financial information differs significantly from that of an audit, and any communication the accountant would make pertaining to interim financial reporting would be limited, as discussed in AU sec. 722, to matters the accountant considered when conducting the review of interim financial information.

The proposed amendments to other PCAOB standards accompanying the repropose standard included an amendment to AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. This amendment would have required the auditor to communicate to the audit committee material misstatements if the client did not agree to revise the accompanying information. This amendment was removed from the amendments accompanying Auditing Standard



No. 16 because the Board has proposed to supersede AU sec. 551 as part of its standard-setting project related to auditing supplemental information.<sup>142</sup>

QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, states that to minimize the risk of misunderstandings regarding the nature, scope, and limitations of services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services.<sup>143</sup> To align with Auditing Standard No. 16, the repropoed standard proposed an amendment to QC sec. 20 to change "client" to "audit committee." One commenter indicated that QC sec. 20 applies to attest engagements as well as to audit engagements. This commenter suggested that instead of replacing "client" with "audit committee," a clarifying footnote be added to the word "client" to indicate that with respect to a financial statement audit or an audit of internal control over financial reporting, the auditor is required to establish an understanding of the terms of the audit engagement with the audit committee. The Board considered this comment and decided not to amend QC sec. 20 at this time. Changes to the Board's quality control standards will be considered as part of the Board's quality control standard-setting project.

### **Audits of Brokers and Dealers**

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")<sup>144</sup> gave the Board oversight of the audits of brokers and dealers

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<sup>142</sup> See *Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*. PCAOB Release No. 2011-005 (July 12, 2011).

<sup>143</sup> QC sec. 20.16.

<sup>144</sup> Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

registered with the SEC. In September 2010, the Commission issued interpretive guidance clarifying that the references in Commission rules and staff guidance and in the federal securities laws to generally accepted auditing standards ("GAAS") or to specific standards under GAAS, as they relate to nonissuer brokers or dealers, should continue to be understood to mean the auditing and attestation standards established by the American Institute of Certified Public Accountants ("AICPA"), but noted that it intended to revisit this interpretation in connection with a SEC rulemaking project to update the audit and attestation requirements for brokers and dealers in light of the Dodd-Frank Act.<sup>145</sup> On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.<sup>146</sup>

If the SEC adopts its proposed amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the Board's auditing, attestation, quality control, and, where applicable, independence standards would then apply to audits of brokers and dealers as required by Section 17 of the Exchange Act and SEC Rule 17a-5.<sup>147</sup>

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<sup>145</sup> SEC, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, Exchange Act Release No. 62991 (Sept. 24, 2010).

<sup>146</sup> SEC, *Broker-Dealer Reports*, Exchange Act Release No. 64676 (June 15, 2011).

<sup>147</sup> 17 C.F.R. § 240.17a-5.

Further, if the SEC adopts its proposed amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB standards, prior to the effective date of Auditing Standard No. 16,<sup>148</sup> the Board's interim standard, AU sec. 380, would be in effect for audits of brokers and dealers conducted for periods prior to the effective date of Auditing Standard No. 16. The Board's interim standard, AU sec. 380, which was last amended in 1999, indicates that it is not applicable to the audit of a broker or dealer if the broker or dealer does not have an audit committee<sup>149</sup> or is registered with the SEC only because of Section 15(a) of the Exchange Act.<sup>150</sup> Conversely, the auditor communication requirements under GAAS, which are contained in Statement on Auditing Standards ("SAS") 114, *The Auditor's Communication With Those Charged With Governance*, which was issued by the Auditing Standards Board ("ASB") of the AICPA in 2006, are applicable to audits of all brokers and dealers.<sup>151</sup> Because of this difference in the applicability of the auditor

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<sup>148</sup> As noted in this release, the Board anticipates that Auditing Standard No. 16 will be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

<sup>149</sup> AU sec. 380.01 states that the communications required by AU sec. 380 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee).

<sup>150</sup> See AU sec. 380.01, which states that the communications required by the standard "are applicable to . . . all Securities and Exchange Commission (SEC) engagements." As noted in footnote 2 to AU sec. 380.01, the audits of brokers and dealers do not fall within an SEC engagement as defined in AU sec. 380 if the broker or dealer is registered only because of Section 15(a) of the Exchange Act.

<sup>151</sup> See paragraph 1 of SAS 114 which states "[t]his statement . . . establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements," and section 5.129 of the *AICPA Audit & Accounting Guide: Brokers and Dealers in Securities* (July 2010), which

communication standards to the audits of brokers and dealers, there could be a gap in required audit committee communications if the SEC amendments to SEC Rule 17a-5 are adopted and become effective prior to the effective date of Auditing Standard No. 16. To eliminate this gap, the Board is amending AU sec. 380 to delete the current exception for audits of brokers and dealers that do not have an audit committee or are registered with the SEC only because of Section 15(a) of the Exchange Act. The transitional amendment would eliminate the above-referenced gap in audit committee communications by making the communication requirements in AU sec. 380 applicable to audits of issuers and brokers and dealers, as those terms are defined in the Sarbanes-Oxley Act, prior to the effective date of Auditing Standard No. 16.

If PCAOB standards are applicable to audits of brokers and dealers prior to the effective date of Auditing Standard No. 16, the communication requirements under Auditing Standard No. 16 would be applicable to the audits of brokers and dealers upon the effective date of the standard.

The release accompanying the repropoed standard posed a question about whether the standard should apply to the audits of all brokers and dealers. Many commenters supported the requirement for the standard to apply to the audits of all brokers and dealers. However, some commenters suggested that it may not be practicable to communicate the matters in the standard because they may not be applicable to all brokers and dealers due to the varying size and nature of the brokers and dealers as well

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states, in part: "AU section 380, *The Auditor's Communication with Those Charged with Governance* ... has been updated for the issuance of SAS No. 114.... AU 380 is applicable to all broker-dealers being audited under GAAS, regardless of their governance structure or size."

as the difference in their governance structures. Some commenters suggested that these brokers and dealers may not have an audit committee, board of directors, or equivalent body, or that the individual designated to oversee the financial reporting process and audits of the company might be the same person preparing the financial statements. They suggested, therefore, that the standard should apply only to certain types of brokers and dealers, such as carrying brokers or dealers. Other commenters suggested that the standard should not be applicable to the audits of brokers and dealers.

The Board acknowledges that there are smaller, less complex brokers and dealers that do not have an audit committee, board of directors, or equivalent body, but that communicating matters about the audit and the financial statements to those overseeing the financial reporting process is important. The governance structure of brokers and dealers does not change the value of the information regarding the audit or the company's financial statements.

Therefore, as discussed in this release, the definition of audit committee was revised for audits of nonissuers to recognize that if no such committee or board of directors (or equivalent body) exists with respect to the company, the communication should be made to the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

The release accompanying the repropoed standard posed a question about whether there are any communication requirements specific to the audits of all brokers and dealers that should be added to the standard. Some commenters suggested that the standard should require additional communication to the audit committee related to the additional attestation reporting to be required for brokers and dealers as proposed in

pending SEC amendments to its Rule 17a-5.<sup>152</sup> Once the amendments to Rule 17a-5 are adopted in final form, the Board may consider adding requirements for communication to the audit committee pertaining to such matters.

### **Emerging Growth Companies**

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."<sup>153</sup>

Auditing Standard No. 16 is the first auditing standard adopted by the Board subsequent to enactment of the JOBS Act and accordingly is subject to a separate determination by the SEC regarding its applicability to audits of EGCs.

The Board is also requesting that the Commission approve the proposed rules, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, for application to audits of EGCs, as that term is defined in Section 3(a)(80) of the Exchange Act. The Board's request is set forth in section D.

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<sup>152</sup> SEC, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, Exchange Act Release No. 62991 (Sept. 24, 2010).

<sup>153</sup> Pub. L. No. 112-106, 126 STAT. 306 (April 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act, 15 U.S.C. § 7213 (a)(3)(C), as added by Section 104 of the JOBS Act.

## **Effective Date**

The Board anticipates that the transitional amendments to AU sec. 380 will be effective, subject to SEC approval, for the periods that PCAOB standards become applicable to audits of brokers and dealers, as designated by the SEC upon adoption of its amendments to SEC Rule 17a-5, if such periods precede the effective date of Auditing Standard No. 16.

The Board anticipates that Auditing Standard No. 16 and related amendments, included will be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

## **Comparison of the Objectives and Requirements of Auditing Standard No. 16, Communications with Audit Committees, to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants**

In developing its original proposed standard, the Board took into account, among other things, the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the ASB of the AICPA. The release accompanying the initial proposed standard and repropose standard included a comparison of the objectives and requirements of the initial proposed standard and repropose standards to the analogous standards of the IAASB and ASB.

The following discussion compares certain significant differences between the objectives and requirements of Auditing Standard No. 16 and the analogous standards of the IAASB and ASB of the American Institute of Certified Public Accountants.

The analogous IAASB standards are:

- International Standard on Auditing ("ISA") 210, *Agreeing the Terms of Audit Engagements*, and

- ISA 260, *Communication with Those Charged with Governance*.

The analogous ASB standards<sup>154</sup> are:

- AU-C Section 210, *Terms of Engagement*, and
- AU-C Section 260, *The Auditor's Communication With Those Charged with Governance*.

Other standards of the IAASB and the ASB, respectively, were considered in this comparison to the extent that they include comparable requirements, including:

- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*,
- ISA 450, *Evaluation of Misstatements Identified during the Audit*,
- ISA 570, *Going Concern*,
- ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*,
- ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*,
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*,

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<sup>154</sup> In October 2011, the ASB issued Statement on Auditing Standards ("SAS") No. 122, *Statements on Auditing Standards: Clarification and Recodification*, which contains the Preface to Codification of Statements on Auditing Standards, *Principles Underlying an Audit Conducted in Accordance with Generally Accepted Auditing Standards*, and 39 clarified SASs. SAS 122 identifies the section within the AICPA codification with "AU-C" section numbers. See <http://www.aicpa.org/RESEARCH/STANDARDS/AUDITATTEST/Pages/audit%20and%20attest%20standards.aspx>



- AU-C Section 450, *Evaluation of Misstatements Identified During the Audit*,
- AU-C Section 600, *Using the Work of Others – Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*,
- SAS 118, *Other Information in Documents Containing Audited Financial Statements*, and
- SAS 126, *The Auditor's Consideration of An Entity's Ability to Continue as a Going Concern (Redrafted)*.

The information presented does not cover the application and explanatory material in the IAASB standards or ASB standards.<sup>155</sup>

This discussion is provided for informational purposes only. It is not a summary of or a substitute for Auditing Standard No. 16 itself. This comparison may not represent the views of the IAASB or ASB regarding the interpretation of their standards.

## **Objectives**

### *PCAOB*

Auditing Standard No. 16 supersedes AU sec. 310 and AU sec. 380. Given the responsibility of many audit committees for the appointment and retention of the auditor,

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<sup>155</sup> Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

Auditing Standard No. 16 combines the requirements from the Board's standards, AU secs. 310 and 380, into one auditing standard.

Auditing Standard No. 16 includes four objectives for the auditor, which reflect both the appointment and retention of the auditor as well as the overall communication responsibilities. 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.

#### *IAASB and ASB*

ISA 210 and AU-C Section 210 both include an objective to establish whether the preconditions for an audit are present. Auditing Standard No. 16 does not include this objective, because some of the related requirements in the ISA and SAS are not applicable to audits performed under PCAOB standards, such as determining whether the financial reporting framework is acceptable. For audits performed under PCAOB standards, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

Both ISA 260 and AU-C Section 260 include an objective for the auditor to promote effective two-way communication between the auditor and those charged with governance. Although Auditing Standard No. 16 does not include a similar objective, the standard encourages effective two-way communication between the auditor and the audit committee. As stated in Auditing Standard No. 16, "communicate to," is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

### **Appointment and Retention**

#### **Significant Issues Discussed with Management In Connection with the Auditor's Appointment or Retention**

##### *PCAOB*

Auditing Standard No. 16 requires the auditor to discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

##### *IAASB and ASB*

ISA 210 and AU-C Section 210 do not include a similar requirement.

### **Establish an Understanding of the Terms of the Audit**

##### *PCAOB*

Auditing Standard No. 16 requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the objective of the audit, the responsibilities of the auditor, and the responsibilities of management. Paragraph 6 of Auditing Standard No. 16 requires the auditor to record the understanding of the terms in an engagement

letter and provide the engagement letter to the audit committee annually. In addition, paragraph 6 of Auditing Standard No. 16 includes a requirement for the auditor to have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Additionally, Auditing Standard No. 16 requires the auditor to decline to accept, continue, or perform the engagement if the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee.

#### *IAASB and ASB*

ISA 210 and AU-C Section 210 require the auditor to agree on the terms of the audit engagement with management and, where appropriate, those charged with governance.

ISA 210 and AU-C Section 210 require the engagement letter to be in writing, although there is no requirement that the engagement letter be given to the audit committee or that it be signed by the audit committee, or its chair on behalf of the audit committee, or that it otherwise be acknowledged by the audit committee. Additionally, ISA 210 states that for recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. Accordingly, ISA 210 permits the auditor to not send a new audit engagement letter or other written agreement each period.

AU-C Section 210 requires the auditor to assess whether circumstances require the terms of the audit engagement to be revised. If the auditor concludes that the terms of the preceding engagement need not be revised for the current engagement, the auditor should remind management of the terms of the engagement, and the reminder should be documented.

Both ISA 210 and AU-C Section 210 also establish requirements for the auditor to determine whether the preconditions for an audit exist. Auditing Standard No. 16 does not include similar requirements, as these requirements were either not applicable to audits performed under PCAOB standards or were addressed through the requirements in Auditing Standard No. 16 for establishing an understanding of the terms of the audit engagement with the audit committee.

ISA 210 requires the auditor to determine whether there are any conflicts between the financial reporting standards and additional requirements supplemented by law or regulation. AU-C Section 210 does not include similar requirements. Auditing Standard No. 16 also does not include similar requirements as they are not relevant to the audits performed under PCAOB standards.

ISA 210 and AU-C Section 210 also include requirements regarding limitation of scope prior to audit engagement acceptance, other factors affecting audit engagement acceptance, and acceptance of a change in the terms of the audit engagement. Auditing Standard No. 16 does not include such requirements as they are not applicable to audits performed under PCAOB standards.

AU-C Section 210 also includes requirements regarding initial audits and re-audits. Auditing Standard No. 16 does not include similar requirements, although similar

requirements are included in the Board's standard, AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

Additionally, ISA 260 and AU-C Section 260 include a requirement for the auditor to communicate with those charged with governance the form, timing, and expected general content of communications. Auditing Standard No. 16 does not include this requirement; however, Auditing Standard No. 16 does not preclude the auditor from communicating these matters to the audit committee.

### **Obtaining Information and Communicating the Audit Strategy**

#### **Obtaining Information Relevant to the Audit**

##### *PCAOB*

Auditing Standard No. 16 requires the auditor to inquire of the audit committee about 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 complements the requirement in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, for the auditor to make inquiries of the audit committee, or equivalent (or its chair) about risks of material misstatement, including inquiries related to fraud risks.<sup>156</sup>

##### *IAASB and ASB*

ISA 260 and the AU-C Section 260 do not contain a similar requirement for the auditor to inquire of matters that might be relevant to the audit, including, but not limited to, knowledge of violations or possible violations of laws or regulations. However, ISA 240 and AU-C Section 240 require the auditor to make inquiries of those charged with

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<sup>156</sup> Paragraphs 5.f. and 54-57 of Auditing Standard No. 12.

governance to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity.

### **Overall Audit Strategy, Significant Risks, and Timing of the Audit**

#### *PCAOB*

Auditing Standard No. 16 requires the auditor to communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit, and discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures. As part of communicating the overall audit strategy, paragraph 10 of Auditing Standard No. 16 requires the auditor to communicate the following matters to the audit committee, if applicable:

- a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;
- b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;
- c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;
- d. The names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

- e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.

In addition, Auditing Standard No. 16 requires the auditor to communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

*IAASB and ASB*

ISA 260 and AU-C Section 260 require the auditor to communicate an overview of the planned scope and timing of the audit. However, ISA 260 and AU-C Section 260 do not require the auditor to communicate significant changes to the planned scope and timing of the audit. Further, ISA 260 and AU-C Section 260 do not include requirements for the auditor to communicate information about specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks, the auditor's use of the work of internal auditors, or the auditor's use of the work of other company personnel and third parties working under the direction of management or the audit committee.

ISA 260 and AU-C Section 260 do not include requirements for the auditor to communicate information about the names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit.

However, ISA 600 and AU-C Section 600, include requirements for the auditor to communicate certain matters to those charged with governance including: an overview of the type of work to be performed on the financial information of the components; an



overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components; instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work; any limitation on the group audit; and fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or other where the fraud resulted in a material misstatement of the group financial statements. In addition, AU-C Section 600 also includes a requirement for the auditor to communicate the basis for the decision to make reference to the audit of a component auditor in the auditor's report on the group financial statements.

### **Results of the Audit**

#### **Accounting Policies and Practices, Estimates, and Significant Unusual Transactions**

##### *PCAOB*

Auditing Standard No. 16 requires the auditor to communicate certain matters relating to accounting policies and practices, estimates, and significant unusual transactions. However, Auditing Standard No. 16 acknowledges that if management communicates matters related to accounting policies and practices, estimates, and significant unusual transactions to the audit committee, the auditor does not need to communicate these matters at the same level of detail as management as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that

the auditor considers critical. In addition, the auditor is required to communicate any omitted or inadequately described matters to the audit committee.

Matters to be communicated include:

- a. Significant accounting policies and practices – (1) management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and (2) the effect on financial 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 in practice.
- b. All critical accounting policies and practices to be used, including: (1) the reasons certain policies and practices are considered critical; and (2) how current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.
- c. Critical accounting estimates – (1) a description of the process management used to develop critical accounting estimates; (2) management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and (3) any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.
- d. Significant unusual transactions – (1) 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 (2) the policies and practices management used to account for significant unusual transactions.

*IAASB*

ISA 260 requires the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

*ASB*

AU-C Section 260 requires the auditor to communicate the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. AU-C Section 260 also provides that, when applicable, the auditor should determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

The ISAs and the AU-Cs do not include a similar requirement for communicating significant unusual transactions.

**Auditor's Evaluation of the Quality of the Company's Financial Reporting**

*PCAOB*

Auditing Standard No. 16 requires the auditor to communicate the following matters to the audit committee:

- a. Qualitative aspects of significant accounting policies and practices.

- 1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements; and
  - 2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.
- b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.
  - c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.
  - d. Significant unusual transactions. The auditor's understanding of the business rationale for significant unusual transactions.
  - e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and related disclosures are in conformity with the applicable financial reporting framework,

including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth.

- f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.
- g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.

#### *IAASB*

ISA 260 requires the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. The ISA provides that, when applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity.

The ISAs do not include a similar requirement for communicating the auditor's understanding of the business rationale for significant unusual transactions.

*ASB*

AU-C Section 260 requires the auditor to communicate the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable the auditor should:

- a. Explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity, and
- b. Determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

The AU-Cs do not include a similar requirement for communicating the auditor's understanding of the business rationale for significant unusual transactions.

**Other Information in Documents Containing Audited Financial Statements**

*PCAOB*

When other information is presented in documents containing audited financial statements, Auditing Standard No. 16 requires the auditor to communicate to the audit

committee the auditor's responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.

AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires that if the auditor identifies a material inconsistency in the other information presented in documents containing audited financial statements, and the other information is not revised by management to eliminate the material inconsistency, the auditor should communicate the material inconsistency to the audit committee. The auditor should also consider other actions, such as revising the audit report to include an explanatory paragraph describing the material inconsistency, as described in paragraph .11 of AU sec. 508, *Reports on Audited Financial Statements*, withholding the use of the report in the document, and withdrawing from the engagement. The auditor should also communicate a material misstatement of fact to the client and the audit committee, if the material misstatement of fact is not corrected.

#### *IAASB*

ISA 720 requires that if the auditor identifies a material inconsistency in the other information in documents containing audited financial statements and revision of the other information is necessary and management refuses to make the revision, then the auditor shall communicate this matter to those charged with governance and (a) include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*; or (b) withhold the auditor's report; or (c) withdraw from the engagement, where withdrawal is possible under applicable law or regulation. ISA 720 also requires the auditor to notify those charged with governance of

the auditor's concern regarding the other information and take any further appropriate action if there is a material misstatement of fact in the other information which management refuses to correct.

*ASB*

SAS 118 contains similar requirements to those in Auditing Standard No. 16.

### **Difficult or Contentious Matters for which the Auditor Consulted**

*PCAOB*

Auditing Standard No. 16 requires the auditor to communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

*IAASB and ASB*

ISA 260 and AU-C Section 260 do not include a similar requirement.

### **Management Consultation with Other Accountants**

*PCAOB*

When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, Auditing Standard No. 16 requires the auditor to communicate to the audit committee his or her views about such matters that were the subject of such consultation.

*IAASB*

ISA 260 does not include a similar requirement.



*ASB*

AU-C Section 260 requires the auditor to communicate to those charged with governance the auditor's views about matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultations occurred.

### **Going Concern**

*PCAOB*

Paragraph 17 of Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee, when applicable, certain matters relating to the auditor's evaluation of the company's ability to continue as a going concern. These matters include (a) If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt; (b) If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events; (c) if the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains, the effects, if any, on the financial statements and the adequacy of the related disclosure and the effects on the auditor's report.

### *IAASB*

ISA 570 requires the auditor to communicate events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. This communication includes whether the events or conditions constitute a material uncertainty; whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and the adequacy of related disclosures in the financial statements.

### *ASB*

SAS 126 requires the auditor to communicate with those charged with governance the nature of the conditions or events identified, the possible effects on the financial statements and the adequacy of related disclosures in the financial statements, and the effects on the auditor's report if, after considering identified conditions or events in the aggregate and after considering management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.

### **Uncorrected and Corrected Misstatements**

#### *PCAOB*

Auditing Standard No. 16 requires the auditor to provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management. Auditing Standard No. 16 also requires the auditor to discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors considered.

Additionally, Auditing Standard No. 16 requires the auditor to communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated. Auditing Standard No. 16 also requires the auditor to communicate to the audit committee those corrected misstatements, other than those that are clearly trivial, related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

*IAASB and ASB*

ISA 450 and AU-C Section 260 include requirements for the auditor to communicate uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. The auditor's communication shall identify the material uncorrected misstatements individually. Additionally, under ISA 450 and the AU-C Section 260, the auditor is required to communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

ISA 450 and AU-C Section 450 require the auditor to request that uncorrected misstatements be corrected. Auditing Standard No. 16 does not require the auditor to make this request, because under SEC rules the financial statements are required to reflect all material correcting adjustments identified by the auditor.

ISA 450 does not include a requirement for the auditor to communicate corrected misstatements to those charged with governance. AU-C Section 260 requires the auditor

to communicate material, corrected misstatements that were brought to the attention of management as a result of audit procedures.

### **Material Written Communication**

#### *PCAOB*

Auditing Standard No. 16 requires the auditor to communicate to the audit committee other material written communications between the auditor and management.

#### *IAASB and ASB*

ISA 260 and AU-C Section 260 require the auditor to communicate to those charged with governance written representations the auditor is requesting.

### **Disagreements with Management**

#### *PCAOB*

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee any 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 auditor's report. Auditing Standard No. 16 also states that disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

#### *IAASB*

The ISAs do not include a similar requirement.

## *ASB*

AU-C Section 260 requires the auditor to communicate disagreements with management, if any.

### **Other Matters**

#### *PCAOB*

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.

#### *IAASB and ASB*

ISA 260 and AU-C Section 260 include a similar requirement for the auditor to communicate other matters to those charged with governance that, in the auditor's professional judgment, are significant and relevant to the oversight of the financial reporting process.

### **Form and Documentation of Communications**

#### *PCAOB*

Auditing Standard No. 16 requires the auditor to communicate the matters in the standard to the audit committee, either orally or in writing, unless otherwise specified in Auditing Standard No. 16. In addition, the standard also requires the auditor to document the communications in the work papers whether such communications took place orally or in writing. Auditing Standard No. 16 also requires the auditor to include a copy of or a

summary of management's communication provided to the audit committee in the audit documentation, if as part of its communications to the audit committee, management communicated some or all of the matters related to accounting policies and practices, estimates, significant unusual transactions, or uncorrected misstatements to the audit committee, and, as a result, the auditor did not communicate these matters at the same level of detail as management.

#### *IAASB*

ISA 260 requires the auditor to communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communication need not include all matters that arose during the course of the audit.

#### *ASB*

AU-C Section 260 requires the auditor to communicate in writing with those charged with governance significant findings or issues from the audit if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved.

#### **Timing**

#### *PCAOB*

Auditing Standard No. 16 requires the communications to the audit committee to be made in a timely manner and prior to the issuance of the auditor's report.<sup>157</sup>

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<sup>157</sup> Auditing Standard No. 16 includes the following exception for registered investment companies – Consistent with SEC Rule 2-07 of Regulation S-X, 17 C.F.R. §

*IAASB and ASB*

ISA 260 and AU-C Section 260 require that the auditor should communicate with those charged with governance on a timely basis.

**D. Request to Apply Auditing Standard No. 16 to Audits of Emerging Growth Companies**

**Introduction and Statutory Background**

On August 15, 2012, the Board adopted Auditing Standard No. 16 (Auditing Standard No. 16 may also be referred to as "the new standard" in this section)<sup>158</sup> pursuant to the Board's authority under the Sarbanes-Oxley Act.<sup>159</sup>

Auditing Standard No. 16 requires auditors to communicate certain significant audit and financial statement matters to the audit committee of the company<sup>160</sup> under

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210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update, in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

<sup>158</sup> *Communications with Audit Committees*, PCAOB Release No. 2012-004 (Aug. 15, 2012).

<sup>159</sup> Pub. L. No. 107-204. Pursuant to Section 101 of the Sarbanes-Oxley Act, the mission of the Board is to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Sarbanes-Oxley Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Act of 2010 expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. *See* Pub. L. No. 111-203.

<sup>160</sup> The term "company" as used in this section is intended to refer to companies whose audits are required to be performed in accordance with PCAOB standards.

audit. Among other things, the required communications include such matters as: (i) the company's critical accounting practices; (ii) significant risks identified by the auditor's risk assessment procedures; (iii) the company's significant unusual transactions; and (iv) when applicable, the auditor's evaluation of the company's ability to continue as a going concern. Communications may be made orally or in writing, but should be made in a timely manner and prior to the issuance of the auditor's report.

In the Board's view, the adoption of Auditing Standard No. 16 is in the public interest and contributes to investor protection because it establishes requirements that enhance the relevance, timeliness, and quality of communications between auditors and audit committees. The enhanced relevance, timeliness, and quality of communications should improve the audit and facilitate audit committees' financial reporting oversight, fostering improved financial reporting. The Board's adopting release dated August 15, 2012, discusses the record developed by the Board in adopting Auditing Standard No. 16 in greater detail.

In addition, the Sarbanes-Oxley Act was recently amended by Section 104 of the JOBS Act<sup>161</sup> to provide that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs<sup>162</sup> unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote

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<sup>161</sup> Pub. L. No. 112-106.

<sup>162</sup> Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."



efficiency, competition, and capital formation."<sup>163</sup> As a result, Auditing Standard No. 16, which was adopted by the Board after April 5, 2012, is subject to a separate determination by the SEC regarding its applicability to audits of EGCs.

The Board is thus requesting that the Commission also take action to apply Auditing Standard No. 16 to audits of EGCs, pursuant to Section 104 of the JOBS Act. In this submission, the Board is providing information to assist the SEC in its consideration of whether it is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation," to apply Auditing Standard No. 16 to audits of EGCs.

The information provided in this submission summarizes the Board's record in adopting Auditing Standard No. 16 and includes a discussion of the following areas to assist the SEC in its consideration pursuant to Section 104 of the JOBS Act: (i) the background of and reasons for the new standard; (ii) the Board's approach to developing the new standard, including consideration of alternatives; (iii) key changes and improvements from existing audit committee communication requirements; and (iv) characteristics of EGCs and economic considerations.

### **Background and Reasons for the New Standard**

The following discussion provides summary information regarding the background and reasons for Auditing Standard No. 16. These matters are also discussed in greater detail in the Board's adopting release.

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<sup>163</sup> See Section 103(a)(3)(C) of the Sarbanes-Oxley Act, as added by Section 104 of the JOBS Act.

Auditing Standard No. 16 would replace PCAOB interim standards AU sec. 380 and AU sec. 310.<sup>164</sup> The existing PCAOB requirements regarding auditor communications with audit committees are primarily in AU sec. 380, while AU sec. 310 discusses establishing an understanding between the auditor and the client regarding the audit engagement.

AU sec. 380 became effective in January 1989, at a time when management typically hired and retained the auditor and had oversight of the work of the auditor. AU sec. 380 indicates that audit committee communications are "incidental to the audit" and are not required to occur prior to the issuance of the auditor's report. AU sec. 380 includes a variety of specified communication requirements.

Subsequently, changes to the federal securities laws and related SEC rules imposed additional communication requirements that are not currently reflected in AU sec. 380. Most significantly, in 2002, the Sarbanes-Oxley Act changed the role of the audit committee and the interaction between the audit committee and the auditor, requiring the auditor of a listed company to report directly to the audit committee. Section 301 of the Sarbanes-Oxley Act made changes to the federal securities laws to require the audit committee of a listed company to be directly responsible for the appointment, compensation, and oversight of the work of the external auditors, including the resolution of disagreements between management and the auditor regarding financial

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<sup>164</sup> Shortly after its inception, the Board adopted the existing standards of the AICPA, as in existence on April 16, 2003, on an initial, transitional basis. *See* PCAOB Release No. 2003-006 (Apr. 18, 2003). References to AU sections ("AU secs.") throughout this document are to these PCAOB interim auditing standards, which consist of generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement on Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board.

reporting. In addition, Section 204 of the Sarbanes-Oxley Act made other changes to the federal securities laws to require the auditor to report the following matters to the audit committee on a timely basis:

- All critical accounting policies and practices to be used;
- All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
- Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

Since the adoption of AU sec. 380, certain PCAOB auditing standards also have changed as a result of the Board's ongoing efforts to revise its interim standards. For example, in 2010 the Board adopted eight standards on assessing and responding to risk in an audit (the "risk assessment" standards), which cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report.<sup>165</sup> The risk assessment standards address, among other things, requirements for the auditor in the areas of audit planning, audit strategy, and risk assessment, including requirements for the auditor to identify significant risks of material misstatement. As one of the PCAOB's interim auditing standards, AU sec. 380's

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<sup>165</sup> See PCAOB Release 2010-004 (Aug. 5, 2010).

communication requirements are not aligned with the procedures performed pursuant to the PCAOB's risk assessment standards, which became effective for audits for fiscal years beginning after December 15, 2010.

Additionally, observations from the Board's oversight activities raised matters for consideration. For example, some inspection observations indicate that auditors have not made all required audit committee communications, possibly because they are not aware of the varying sources of communication requirements contained throughout the Board's standards and rules. Currently, thirteen auditing standards and rules require the auditor to communicate with the audit committee, and other additional communication requirements are located in the federal securities laws and SEC rules.

In light of these changes and considerations, the Board adopted Auditing Standard No. 16 with the goal of improving the audit by enhancing communications between auditors and audit committees. With the passage of the Sarbanes-Oxley Act and the establishment of the PCAOB, Congress acknowledged that auditors play an important role in protecting the interests of investors by preparing and issuing informative, accurate, and independent audit reports.<sup>166</sup> The audit committee also plays an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to a company's shareholders and others to oversee the integrity of a company's accounting and financial reporting processes and audits.

In the Board's view, both the auditor and the audit committee benefit from a meaningful and timely exchange of information regarding significant risks of material

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<sup>166</sup> See Section 101(a) of the Sarbanes-Oxley Act; Senate Report No. 107-206, at 5-6 (July 3, 2002).

misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports. Communications with the audit committee improve the audit by providing auditors with the audit committee's insights about the company as well as providing auditors with a forum separate from management to discuss complex and significant matters about the audit and the company's financial reporting process. Communications between the auditor and the audit committee allow the audit committee to be well-informed about accounting, auditing, and disclosure matters, including the auditor's evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role.

Auditing Standard No. 16 also updates the auditing standards to reflect the communication requirements mandated by the federal securities laws and aligns the audit committee communication requirements with auditor performance requirements, including those in the risk assessment standards. Bringing these requirements together in one place should promote the auditor's compliance with relevant statutory and regulatory requirements (as well as facilitating audit planning and informing audit scope). Updating auditing standards to incorporate new statutory and regulatory requirements can help ensure that audit firms update their audit methodologies to include all required and relevant procedures. Such updating is particularly critical with respect to AU sec. 380 because, as noted earlier, AU sec. 380 treats audit committee communications as "incidental," and does not focus on the important role of the audit committee in the current regulatory environment.

**The Board's Approach to Development of Auditing Standard No. 16, including Consideration of Alternatives**

Auditing Standard No. 16 was adopted by the Board after several years of consideration and public outreach. For example, the issue of auditor communications with the audit committee was discussed with the Board's Standing Advisory Group ("SAG") on several occasions prior to the Board's decision to propose a new standard.<sup>167</sup>

The Board proposed a new standard on March 29, 2010, which was open for comment until May 28, 2010. The comment period reopened on September 7, 2010 and was extended until October 21, 2010, to accommodate comments received in connection with a public roundtable held by the Board on September 21, 2010.

The standard was then repropose on December 20, 2011, and open for comment until February 29, 2012. The Board adopted the new standard on August 15, 2012.

The Board received and considered 44 comment letters on the original proposal, which included the reopened comment period, and 39 comment letters on the repropose standard. Most commenters were supportive of the Board's efforts to enhance communications between the auditor and the audit committee. Those commenters agreed that fuller and more relevant communications between the auditor and audit committee would allow the auditor to perform a more informed, and thus more effective, audit and also would enable the audit committee to more effectively fulfill its oversight responsibilities regarding the financial reporting process.

The Board's adopting release explains in greater detail the Board's consideration of significant comments received and the reasons for making the changes reflected in the new standard. In general, as discussed below, the Board made a number of decisions as it

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<sup>167</sup> The SAG discussed the audit committee communications standard at a number of its meetings, including meetings prior to proposing a new standard on: June 21-22, 2004, June 8, 2005, Oct. 5-6, 2005, and Oct. 14-15, 2009.

developed Auditing Standard No. 16 that make the new standard more efficient and effective to apply, and avoid unnecessary costs. The following summary describes the Board's overall approach and highlights some of the choices made, and alternatives considered.

- Auditing Standard No. 16 is scalable, based on a company's size and complexity. In developing the new standard, the Board sought to promote high-quality audits, while considering the standard's overall effect on current audit practice and on audit committees and companies. In doing so, the Board sought to achieve the standard's intended benefits, without imposing unnecessary costs, and to create a standard that is scalable based on the company's size and complexity. A company's size and complexity can affect the risks of material misstatement, create auditing challenges, and involve other significant matters that warrant bringing to the attention of the audit committee. Thus, an auditor of a smaller, less complex company with fewer difficult auditing or financial reporting issues may have fewer matters to communicate than for an audit of a larger, more complex company. Accordingly, under Auditing Standard No. 16, in an audit of a small, less complex company, an auditor may make less extensive audit committee communications than in an audit of a larger, more complex company. The original proposal asked for comment on whether any of the requirements of the proposed standard were inappropriate based on the size or industry of the company. Commenters

considered the proposed requirements to be applicable and appropriate to companies of different sizes and industries.

- Auditing Standard No. 16 has been carefully designed to: (i) retain the pre-existing communication requirements in auditing standards; (ii) incorporate the communication requirements already imposed by the Sarbanes-Oxley Act and related SEC rules; and (iii) link new communications to related performance requirements arising out of the Board's existing auditing standards. As a result of this approach, the auditor's communications under the new standard are limited to *communicating* the results of the audit or specific audit procedures already required under the existing standards. Auditing Standard No. 16 does not impose new performance obligations on the auditor, other than the standard's required communications.
- Auditing Standard No. 16 organizes and compiles information regarding other PCAOB auditor communication requirements. Auditing Standard No. 16 contains an appendix that lists in one place other PCAOB standards and rules that require the auditor to communicate specific matters to the audit committee. This aspect of the new standard responds to observations from the Board's oversight activities that suggest that auditors may not make all required audit committee communications because they might not be aware of the varying sources of such requirements. This convenient list facilitates auditors' identification of



other PCAOB standards and rules that contain communication requirements.

- Auditing Standard No. 16 focuses on the communication of significant matters relating to the audit. In developing the new standard, the Board sought to focus on communication of significant matters relating to the audit. In response to comments, the requirements in Auditing Standard No. 16 were changed from the original proposal to focus the auditor on communicating matters that are significant to the audit committee's oversight of the financial reporting process. For example, changes were made to limit communications regarding the need for specialized skill or knowledge in the audit to only those relevant to significant audit risks. Similarly, the standard was narrowed to require communications relating to matters on which the auditor consulted to only those 'difficult or contentious' matters that are relevant to the audit committee's oversight of the financial reporting process.
- Auditing Standard No. 16 provides the auditor with flexibility to communicate orally or in writing. AU sec. 380 provides the auditor with the flexibility to communicate orally or in writing. Several commenters to both the original proposal and the reproposal suggested that the communications to the audit committee should be required to be in writing. The Board considered this approach, but determined that requiring all communications to be in writing could reduce the effectiveness of the communication process. The Board's goal is to

promote effective two-way communication between the auditor and the audit committee, whether through presentations, written reports, or interactive discussions. Allowing different forms of communication also makes the communication requirement more flexible for companies of all sizes and natures.

- Auditing Standard No. 16 recognizes that management, as well as the auditor, may discuss issues relating to the company's financial statements with the audit committee, and that it would not be cost-effective or practical for the audit committee to receive the same communication twice. With respect to certain auditor communications, the new standard provides that the auditor need not duplicate communications made by management at the same level of detail, so long as certain conditions specified in Auditing Standard No. 16 are met.<sup>168</sup> These changes allow for better use of auditor, management, and audit committee time and resources while, at the same time, help to ensure that the audit committee is informed of important accounting issues.
- Auditing Standard No. 16 reflects practical considerations. The scope of the new standard was narrowed in response to practical concerns raised during the comment process. For example, the original proposed standard included a requirement for the auditor to evaluate whether the two-way communications between the auditor and the audit committee were

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<sup>168</sup> See note to Paragraph 12 of Auditing Standard No. 16 and discussion in PCAOB Release No. 2012-004 (Aug. 15, 2012) at pages A4-24 to A4-25.

adequate to support the objectives of the audit. Commenters were concerned that the evaluation might not be effective, as it would reflect only the auditor's evaluation of the communications, and would not provide information about the audit committee's understanding of the nature of the communications. The Board agreed and did not adopt the requirement.

### **Key Changes and Improvements from Existing Standards**

The following discussion provides a summary of the existing standards relating to auditor communications. The summary also includes a discussion of improvements that have been made in the new standard that should benefit audit quality. These matters also are discussed in greater detail in the Board's adopting release.

*Existing Requirements.* As previously noted, the existing requirements for communications with the audit committee are primarily in AU sec. 380. In addition, AU sec. 310 requires the auditor to establish an understanding with the client regarding the audit engagement.

*Requirements Retained from Existing Standard.* The new standard retains from AU sec. 380 the following audit committee communication requirements:

- Major issues discussed with management prior to the retention of the auditor;
- The company's significant accounting policies and practices;
- The auditor's responsibility related to other information in documents containing audited financial statements;
- Difficulties encountered in performing the audit; and

- Disagreements with management.

*Incorporation of Statutory Communication Requirements.* Auditing Standard No. 16 also incorporates the following specific auditor communication requirements contained in Exchange Act Section 10A(k) and SEC Rule 2-07 of Regulation S-X ("SEC Rule 2-07"):

- All critical accounting policies and practices to be used;
- All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
- Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.<sup>169</sup>

*Improvements Made to Existing Communication Requirements.* While Auditing Standard No. 16 retains many of the communication requirements in AU sec. 380, it also revises certain requirements to be consistent with existing audit performance requirements or to respond to other requirements in the Sarbanes-Oxley Act as well as SEC Rule 2-07. The new standard improves current communication requirements in the following areas:

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<sup>169</sup> See Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k), and implementing changes in Rule 2-07(a)(1)-(3) of Regulation S-X, 17 C.F.R. § 210.2-07(a)(1)-(3).

- Timing/Shift in Approach to Audit Committee Communications. AU sec. 380 provides that audit committee communications are "incidental to the audit." While AU sec. 380 requires auditors to "discuss" or determine that the audit committee is "informed" regarding a range of matters on a timely basis, AU sec. 380 also provides that communications are not required to occur prior to the issuance of the auditor's report. The new standard indicates that communications between the auditor and the audit committee are integral to the audit and that communications should occur in a timely manner and prior to the issuance of the auditor's report. By requiring communications prior to the issuance of the auditor's report, Auditing Standard No. 16 makes a significant difference in the standard regarding the timing of communications by giving auditors and audit committees the ability to take appropriate action to address the matters communicated, including any effect on the company's financial statements. This timing requirement aligns with the timing of communications required by Exchange Act Section 10A(k) and SEC Rule 2-07.
- Understanding the Terms of the Audit and the Engagement Letter. AU sec. 310 requires the auditor to establish an understanding with the "client" regarding the terms of the audit and services to be performed. Auditing Standard No. 16 retains the requirement for the auditor to establish an understanding of the terms of the audit engagement and the services to be performed, but requires the understanding to be with the audit committee.

The new standard also requires that the understanding be recorded in an engagement letter. These changes align the new standard with the audit committee's oversight of the work of the external auditor.<sup>170</sup> These new requirements also build on the requirement in AU sec. 310 for the auditor to document the understanding in the working papers, preferably through a written communication with the client. Having a mutually clear understanding of the terms of the engagement, including the objectives of the audit, the responsibilities of the auditor, and the responsibilities of management in connection with the audit, should benefit both the auditor and the audit committee.

- Definition of "Audit Committee." AU sec. 380 does not have a formal definition of audit committee, but describes the audit committee as "those that have responsibility for oversight of the financial reporting process." Auditing Standard No. 16 incorporates the definition of audit committee used in the Sarbanes-Oxley Act and modifies the Sarbanes-Oxley Act's definition for companies that are nonissuers, such as brokers and dealers.
- Qualitative Aspects of the Company's Financial Reporting. AU sec. 380 requires the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles, including the consistency of the entity's accounting policies and their application, and the clarity and completeness of the

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<sup>170</sup> See Section 301 of the Sarbanes-Oxley Act, and Section 10A(m)(2) of the Exchange Act, 15 U.S.C. § 78j-1(m)(2).

entity's financial statements and related disclosures. Many commenters indicated that it was unclear what was meant by the quality, clarity, and completeness of the company's financial statements and related disclosures. Auditing Standard No. 16 aligns the communication requirement with an underlying performance requirement in Auditing Standard No. 14, *Evaluating Audit Results*. Under this approach, the auditor communicates, among other things: (i) the results of the auditor's evaluation of and conclusions about the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments and (ii) the results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including such matters as consideration of the form, arrangement, and content of the financial statements. This approach aligns with existing performance requirements and was favored by most commenters.

- Critical Accounting Estimates. AU sec. 380 requires the auditor to determine that the audit committee is informed about the process used by management in formulating "particularly sensitive" accounting estimates. Auditing Standard No. 16 largely retains the auditor communication requirement from AU sec. 380, but uses the term "critical accounting

estimates," which conforms to the term used by the SEC.<sup>171</sup> Auditing Standard No. 16 adds related requirements to communicate matters pertaining to management's significant assumptions and changes to the process or assumptions used to develop critical accounting estimates. These additional requirements address communication of the results of the auditor's procedures performed under AU sec. 342, *Auditing Accounting Estimates*. The purpose of this communication is to focus the audit committee's attention on the estimates that might be subject to higher risk of material misstatement.

- *Uncorrected and Corrected Misstatements*. Auditing Standard No. 16 incorporates the communication requirements from AU sec. 380 related to uncorrected and corrected misstatements. In addition, Auditing Standard No. 16 incorporates the requirement from the Sarbanes-Oxley Act and SEC Rule 2-07 for the auditor to report to the audit committee other material written communications between the auditor and management, such as a schedule of unadjusted differences.
- *Significant Unusual Transactions*. AU sec. 380 requires the auditor to determine that the audit committee is informed about the methods used to account for significant unusual transactions. Auditing Standard No. 16 revises the requirement by adding requirements based on the auditor's

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<sup>171</sup> See SEC, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 8350 (Dec. 19, 2003).



procedures under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for the auditor to communicate: (i) significant transactions that are outside the normal course of business for the company or otherwise appear to be unusual due to their timing, size, or nature and (ii) the auditor's understanding of the business rationale for significant unusual transactions. Communications of significant unusual transactions by the auditor will improve audit quality by promoting discussion of such transactions. It will also allow the audit committee to gain insight into such transactions and take appropriate actions, if necessary, to address the financial statement or disclosure impact of such transactions.

- Management Consultations with Other Accountants. When the auditor is aware that management consulted with other accountants about auditing and accounting matters, AU sec. 380 requires the auditor to discuss with the audit committee the auditor's views about significant matters that were the subject of such consultation. Auditing Standard No. 16 modified this requirement. The new standard requires the auditor to communicate to the audit committee only when the auditor has identified a concern regarding such consultations. Commenters viewed this change as an improvement as they noted that it may be good practice for management to consult with other accountants as experts to assist them regarding complex accounting matters, but that the audit committee need not be informed of all such

consultations, rather just those matters for which the auditor identified a concern.

- Obtaining Information Relevant to the Audit. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to inquire of the audit committee regarding the matters important to the identification and assessment of risks of material misstatement, including fraud risks. Pursuant to Auditing Standard No. 16, the auditor also inquires about whether the audit committee is aware of additional matters relevant to the audit. As a result, the auditor has an opportunity to focus on any additional matters relevant to the audit, such as possible violations of laws or regulations. This inquiry requirement might enable the auditor to learn from the audit committee about a possible previously unidentified risk.

*New Communication Requirements.* Auditing Standard No. 16 also contains new communication requirements that improve the audit by promoting discussion about significant aspects of the audit, while also providing valuable information to the audit committee. These new communications relate to audit procedures that already will be performed under existing PCAOB standards, with the auditor communicating the results of such procedures to the audit committee. The new communication requirements include:

- Overall Audit Strategy and Significant Risks. Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee an overview of the overall audit strategy, including the timing

of the audit, and to discuss with the audit committee significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks. These changes are aligned with the results of the audit procedures performed under the PCAOB's risk assessment standards, in particular, Auditing Standard No. 9, *Audit Planning*, and Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- Other Participants in the Audit. Auditing Standard No. 16 requires the auditor to communicate, as applicable, information about specialized skill or knowledge needed for the audit. In addition, the auditor is required to communicate: (i) information regarding other participants in the audit, such as the extent of the use of internal auditors, company personnel, other third parties (including other independent public accounting firms), or other persons not employed by the auditor that are involved in the audit and (ii) the basis for the auditor's determination that the auditor can serve as the audit engagement's principal auditor, if significant parts of the audit are performed by other auditors. The communications related to others involved in the audit, including the nature and extent of their involvement, could be important for an audit committee to understand in its oversight of the audit. These communications should reflect the results of other audit procedures that the auditor is currently required to perform in accordance with PCAOB standards.

- Difficult or Contentious Matters for which the Auditor Consulted.  
Auditing Standard No. 16 requires the auditor to communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process. Audit committees might better appreciate the importance of difficult or contentious matters, benefiting their governance responsibility, if they are aware that such consultations took place. Communications are based on the results of the procedures the auditor performed regarding difficult or contentious matters.
- Going Concern. Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to the auditor's evaluation of the company's ability to continue as a going concern. The communication requirements in Auditing Standard No. 16 are based on the auditor's performance requirements under AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. This communication enables the auditor to improve the audit by facilitating discussion between the auditor and the audit committee about the company's ability to continue as a going concern. This communication also can serve to further inform the audit committee, by focusing attention on financial difficulties the company is encountering. Through this communication, the auditor can benefit from the audit committee's views of the concerns identified by the auditor. Such communications also could

be significant in terms of the audit committee's role in overseeing the company's financial reporting process to ensure that the company's financial statements contain the necessary disclosures.

- Other Matters. Auditing Standard No. 16 requires the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process, such as complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit. The auditor benefits from a robust discussion of such complaints or concerns with the audit committee. Also, the audit committee should be better able to exercise its oversight activities if the auditor informs the audit committee of these matters. Communication to the audit committee is based on the results of the auditor's procedures relating to such other matters.
- New Accounting Pronouncements. Auditing Standard No. 16 requires the auditor to communicate to the audit committee situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting. This communication informs the audit committee of situations relevant to the audit committee's oversight of the company's financial reporting process. Auditing Standard No. 16 requires only that the auditor communicate concerns identified as a

result of existing audit performance requirements and does not require the auditor to perform additional procedures to identify such concerns.

- Departure from the Auditor's Standard Report. Auditing Standard No. 16 requires the auditor to communicate to the audit committee when the auditor expects to: (i) modify the opinion in the auditor's report or (ii) include explanatory language or an explanatory paragraph in the auditor's report. The requirement is intended to provide the basis for a discussion between the auditor and the audit committee in those circumstances in which the auditor expects to change the auditor's standard report. This requirement is limited to the communication of changes to the audit report determined by the auditor during the course of the audit and does not require the performance of new audit procedures.

*Other Considerations Relating to Changes to the Standard.* As part of the Board's regular standard-setting process, the Board takes into account costs related to its proposed changes based on, among other things, the Board's general knowledge of audit firm practice based on the Board's oversight activities. The Board did not specifically seek or receive comment that attempted to quantify costs related to the new standard.<sup>172</sup>

The Board has sought to devise an overall framework for auditor communications that is sensitive to the new standard's overall effect. The Board has sought to avoid unnecessary costs in developing the new standard. To the extent that the new standard changes

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<sup>172</sup> The discussion in this section reflects the Board's qualitative assessment of the new standard's impact based on the overall design of the new standard, and the changes made by the Board in response to comments, both of which are discussed throughout this submission and in the record for Auditing Standard No. 16.

existing or imposes new communication requirements, however, the Board recognizes that those requirements will impose some incremental costs.

To avoid unnecessary costs:

- Auditing Standard No. 16 incorporates significant existing and new communication requirements into one standard. Bringing these requirements together in one place should promote the auditor's compliance with relevant statutory and regulatory requirements, as well as potentially reducing auditor time searching for requirements. Similarly, an appendix to the new standard lists and identifies the location of other auditor communication requirements contained in other PCAOB rules and standards; and
- The new standard does not impose new auditor performance requirements, other than the required communications themselves. In other words, the new audit committee communication requirements in Auditing Standard No. 16 are based on the results of audit procedures performed under existing standards.

In considering costs, as a threshold matter, the Board notes that auditors and audit committees already engage in audit committee communications under the federal securities laws and existing auditing standards and thus registered firms and companies already incur some costs in complying with existing requirements.

Registered firms will need to incur the one-time cost to update their audit methodologies to reflect the new requirements and conduct initial training of their

personnel on the new requirements.<sup>173</sup> In addition, registered firms will incur the recurring costs of the additional time required to prepare and make the communications in each audit in which they are required and to document that those communications were made. The Board also recognizes that audit committees will need to receive or read, and potentially discuss and act upon, the new required communications, which might result in the ongoing cost of increased time required for audit committee meetings. The Board sought to ensure that the recurring communication requirements are scalable – that is, they vary based on the size and complexity of the company – in part to avoid unnecessary costs.

For all the reasons discussed above and in the Board's adopting release, the Board does not anticipate the incremental costs imposed by the new standard would be significant.

### **Characteristics of EGCs and Economic Considerations**

The PCAOB has begun to monitor implementation of the JOBS Act in order to understand the characteristics of EGCs and inform the Board's request to apply Auditing Standard No. 16 to audits of EGCs.<sup>174</sup>

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<sup>173</sup> Those firms that in the past did not use an engagement letter for audits subject to the standard will now have to develop one. In the Board's experience, most firms currently use an engagement letter for such audits.

<sup>174</sup> Pursuant to the JOBS Act, an "emerging growth company" is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently competed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act registration statement did not occur on or before December 8, 2011). *See* JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities



To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and June 4, 2012, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed their EGC status have been identified.<sup>175</sup>

*Characteristics of Self-Identified EGCs.* As of June 4, 2012, based on the PCAOB's research, 196 entities have voluntarily identified themselves as EGCs in SEC filings. These 196 entities operate in diverse industries. The five most common Standard Industrial Classification (SIC) codes applicable to these entities are for: blank checks; pharmaceutical preparations; prepackaged software services; computer processing/data preparations services; and crude petroleum/natural gas.

Of the 196 entities, approximately 78% are companies that were identified in a registration statement filed to conduct an initial public offering. The other 22% were identified through Exchange Act filings. Forty-one entities have securities listed on a national securities exchange.

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under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

<sup>175</sup> The PCAOB has not validated these entities' self-identification as EGCs. The information presented in this submission also does not include data for entities that have confidentially submitted draft registration statements to the SEC for confidential non-public review in accordance with the JOBS Act. Thus, the data and analysis are not based on the complete population of EGCs. The Board recognizes that its initial analysis of self-identified EGCs does not include all entities that may be EGCs and that, after the JOBS Act has been in effect for a longer period of time, additional analysis of the characteristics of EGCs may be possible.

The reported assets for the 196 entities ranged from zero to approximately \$13 billion, based on filings for the period reported. The average and median reported assets of the 196 entities were approximately \$260.6 million and approximately \$24.9 million, respectively.<sup>176</sup> The reported revenue for the 196 entities, based on filings for the period reported, ranged from zero to approximately \$958.1 million. The average and median reported revenue of the 196 entities was approximately \$106.9 million and approximately \$6.7 million, respectively. Seventy-eight of the 196 entities identified themselves as "development stage entities" in their financial statements.<sup>177</sup> Of the 196 entities, 103 were audited by firms that are annually inspected by the PCAOB (i.e., firms that have issued audit reports for more than 100 public company audit clients). The remaining 93 were audited by triennially inspected firms (i.e., firms that have issued audit reports for 100 or fewer public company audit clients).

Based on the Board's initial analysis of EGCs, these entities appear to represent diverse industries and are audited by a diverse group of firms. Although these entities

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<sup>176</sup> For purposes of comparison, the PCAOB compared the data compiled with respect to the 196 entities with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 was approximately \$11.5 billion and approximately \$1.4 billion, respectively. The average and median reported revenue of issuers in the Russell 3000 was approximately \$4.6 billion and \$742.8 million, respectively.

<sup>177</sup> According to Financial Accounting Standards Board ("FASB") guidance, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which *either* of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations.) *See* FASB Accounting Standards Codification, Subtopic 915-10, *Development Stage Entities – Overall*.

range in size, approximately 61% or 119 have reported revenue of less than \$50 million. Given the December 8, 2011, initial starting point for EGC eligibility, one key difference between EGCs and other entities appears to be the length of time an EGC has been subject to the reporting requirements under the Exchange Act.<sup>178</sup>

*Economic Considerations and Application of Auditing Standard No. 16 to Audits of EGCs.* The Board adopted Auditing Standard No. 16 to "further the public interest in informative, accurate, and independent audit reports." Auditing Standard No. 16 is intended to improve the relevance, timeliness, and quality of communications between auditors and audit committees. The Board's determination to adopt Auditing Standard No. 16 is based on a record developed over several years that includes extensive public outreach and comment.

As discussed above and in the Board's release, improved communications should result in both auditors and audit committees becoming better informed and, therefore, better equipped to fulfill their respective roles in the company's financial reporting. Through this communication, the auditor may obtain more complete information about the company, enabling the auditor to be more effective in identifying and assessing risks of material misstatement in the company's financial statements and designing and performing audit procedures to address those risks. Similarly, a better informed audit committee should contribute to management oversight, which may also improve the company's financial reporting as well as its oversight of management more generally.

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<sup>178</sup> The Board notes that its initial analysis is generally consistent with the legislative history of the JOBS Act, which anticipated that EGCs will be somewhat smaller entities that may have less experience in complying with some aspects of the federal securities laws. *See* House Report No. 112-406, at 5-7.

The Board believes the standard will enhance the quality of the audit and the quality of the financial reporting process. In attempting to obtain these benefits through the new standard, the Board sought to avoid imposing unnecessary costs. The approach used by the Board was to consider the new standard's overall effect on current audit practice and on audit committees and companies. This approach was used to develop a standard that is scalable based on a company's size and complexity, thereby avoiding unnecessary costs for audits of smaller or less complex companies, including smaller or less complex companies that are EGCs.

The benefits of the standard, which are summarized throughout this submission and described more fully in the Board's adopting release, should also be applicable to companies of various types and natures. For example, auditors and audit committees of all types of companies should benefit from a meaningful exchange of information regarding significant matters that may affect the integrity of a company's financial reports. Communications with the audit committee should improve the audit by providing auditors with the audit committee's insights about the company, as well as providing auditors with a forum that is separate from management to discuss complex and significant matters about the audit and the company's financial reporting process. Communications between the auditor and the audit committee should allow the audit committee to be well-informed about accounting, auditing, and disclosure matters that are significant to the company's financial statements, and to be better able to carry out its oversight role. These general benefits of the new standard should accrue to audits of all companies, including EGCs.

Moreover, enhanced audit committee communications may be of particular benefit to EGCs. Based on the Board's preliminary analysis of EGC data, EGCs generally appear to be companies that are relatively new to the SEC reporting process. Such companies may have new audit committee members and may be relatively less familiar with SEC reporting requirements, and have relatively more questions regarding how to present their financial statements for SEC reporting purposes. Similarly, some EGCs may be considering for the first time initial choices in their accounting policies and practices that could have implications for their financial reporting.

Another benefit of the new standard is that it provides for communications regarding significant matters on a timely basis. Timely communications with the audit committee help improve the audit by, among other things: (i) informing the audit committee, which has responsibility for the oversight of financial reporting, about significant matters related to the audit and the financial statements; (ii) enabling the auditor to obtain the audit committee's insights and information about transactions and events; (iii) enabling the auditor to learn from the audit committee about additional matters relevant to the audit, including possible violations of laws or regulations; and (iv) assisting the auditor in gaining a better understanding of the company and its environment. Timely communications also permit both the auditor and the audit committee to take appropriate action to address the matters communicated, including any effect on the company's financial statements. Again, these benefits were designed to benefit audits of all companies, including audits of EGCs.

The new standard also promotes communications that are tailored to the circumstances of the company and informative, rather than "boiler-plate" or standardized.

Under Auditing Standard No. 16, required communications would vary by the nature and complexity of the company being audited. Effective communication between the auditor and the audit committee also need not be in writing, but may involve many forms of communication, such as presentations, charts, and robust discussions, as well as written reports. Such flexibility in the form of communications is an important element of the new standard and part of what allows the standard to work for audits of companies of varying sizes and complexity, including EGCs.

The Board has also considered other potential economic effects on efficiency and capital formation. The Board's overall approach is designed to: (i) scale the required communications to the size and complexity of the company being audited; (ii) maintain flexibility (for example, with respect to communicating orally or in writing); (iii) minimize duplicative or redundant communications to the audit committee from the auditor and management; (iv) focus the communications on the accounting matters that are significant to the auditor and the audit committee; and (v) reduce auditors' search costs (i.e., the costs associated with researching the federal securities laws' and auditing standards' various communication requirements) by providing a list of other PCAOB standards and rules that contain audit committee communication requirements in one place. Moreover, as previously discussed, the auditor's requirements under the new standard are focused on communicating the results of audit procedures that the auditor is already required to perform.

The Board also considered alternatives to the communication requirements in the final standard. Before commencing this project, the Board considered whether a new standard was necessary, particularly since a number of the standard's requirements were

already required by existing auditing standards or provisions of the federal securities laws. The Board also discussed whether to develop a new standard on audit committee communications with its SAG, and had subsequent discussions with the SAG on the nature and extent of communications in a new standard. The Board proposed the standard, extended the proposal's comment period, held a roundtable, and repropoed the standard to obtain additional public input. As a result of the public comment and outreach, through which many commenters were supportive, the Board decided to proceed with a new standard. The Board did so because it believes that establishing the new communication requirements, as well as clarifying, updating and consolidating the other communication requirements, would improve audits and audit committee oversight with respect to all types of companies, including EGCs, without imposing unnecessary costs.

Many now agree that the interaction between the auditor and the audit committee – as mandated by the Sarbanes-Oxley Act – improves audit quality and the quality of financial reporting.<sup>179</sup> Research has indicated that improved auditor communications with audit committees can enhance the quality of the audit and the quality of the financial

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<sup>179</sup> For example, research conducted by the Center for Audit Quality and published in its March 2008, *Report on the Survey of Audit Committee Members*, found that increased audit committee oversight was believed to have had a positive impact on the overall quality of audits by 92% of its audit committee member respondents. As recently as June 12, 2012, the United Kingdom's Financial Reporting Council issued its annual report, *Audit Quality Inspections*, which indicate, among other things, that: "Audit committees play an essential role in ensuring the quality of financial reporting. In particular, their work with auditors in planning the audit and reviewing its results contributes greatly to the quality of the audit."

reporting process.<sup>180</sup> Also, most commenters on the new standard generally agreed that fuller and more relevant communications between the auditor and audit committee would allow the auditor to perform a more informed, and thus more effective audit, and would enable the audit committee to more effectively fulfill its oversight responsibilities regarding the financial reporting process.<sup>181</sup>

Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.<sup>182</sup> Academic research indicates that improving the quality of financial reporting can reduce investors'

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<sup>180</sup> See, e.g., Jeff Cohen, Ganesh Krishnamoorthy, and Arnie Wright, *Views to Strengthen Auditor Independence and Skepticism*, PCAOB meeting (March 22, 2012). Among other things, the statement provides: "Our research has validated the very important role the audit committee plays in enhancing audit and financial reporting quality." See also Jeffrey Cohen, Lisa Milici Gaynor, Ganesh Krishnamoorthy, and Arnold M. Wright, *Auditor Communications with the Audit Committee and the Board of Directors: Policy Recommendations and Opportunities for Future Research*, Accounting Horizons, at 183 (June 2007) ("Frequent communications with a well-informed, financially sophisticated audit committee and communications among the audit committee, the auditor and the full board improve financial reporting quality.").

<sup>181</sup> For a discussion of comments received on the new standards, see PCAOB Release No. 2012-004 (Aug. 15, 2012) and PCAOB Release No. 2011-008 (Dec. 20, 2011).

<sup>182</sup> Shareholders and other financial statement users possess less information about the company than the company's management. This information asymmetry can provide an opportunity for management to act in ways that are not aligned with the interests of the company's investors. See, e.g., Greenwald, B. C., and J. E. Stiglitz, *Asymmetric Information and the New Theory of the Firm: Financial Constraints and Risk Behavior*, 80 American Economic Review 2, at 160-165 (1990). Also, information asymmetry between informed and uninformed investors makes the latter less willing to trade and require higher risk premiums when they do invest. See, e.g., Easley, D., and M. O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 4, at 1553-1583 (2004).



uncertainty about the information being provided in companies' financial reports and thus increase efficiency in capital allocation and foster capital formation.<sup>183</sup> Higher quality financial reporting (and improved corporate governance) can mitigate principal-agent problems and reduce agency costs.<sup>184</sup>

There will be some costs associated with audit committee communications under the new standard, including additional costs incurred by companies. As previously discussed, the costs for a company to operate and maintain an audit committee may increase because of the need for additional meetings and increased audit committee member time demands. However, for the reasons explained above, the Board does not believe these additional costs will significantly expand the time or resources companies spend on audit committees.

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<sup>183</sup> See, e.g., Lambert R. A., C. Leuz, and R. E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research*, at 385-420 (2007). The authors show that accounting information influences a company's cost of capital directly and indirectly. Improved financial reporting quality can reduce a company's cost of capital by increasing precision of investors' assessments of a company's future cash flows. The lower cost of capital can subsequently affect real investment choices of the company, improving future cash flows and increasing the value of the company. See also Easley, D., and M. O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 4, at 1553-1583 (2004). Their model suggests that increasing reliable public information about a company reduces the risk premium investors require. Also, Lambert et al. (2012) show that cost of capital decreases with higher average precision of information. See Lambert R. A., C. Leuz, and R. E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance*, at 1-29 (2012).

<sup>184</sup> In a principal-agent situation, the goals of principals and agents generally differ and it is expensive for the principals to directly verify the agents' actions. In a corporation, management acts as agent for the shareholders (principals), with the audit committee and the auditor serving as intermediary agents. Well informed intermediary agents can more effectively exercise their oversight responsibilities to mitigate undesired behaviors of the management and reduce the goal incongruence between management and shareholders.

With respect to competition, as noted above, the standard is designed to be scalable based on a company's size and complexity. The required communications can be tailored or adjusted to fit the size and nature of the company under audit. By doing so, the Board sought to avoid imposing unnecessary costs that could have a disproportionate effect on, and thereby potentially have an adverse competitive impact on, smaller and less complex public companies. In response to the Board's solicitation of comment on the appropriateness of the standard's requirements for audits of companies of different sizes and in different industries, commenters generally considered the requirements of the standard to be applicable and appropriate to companies of varying sizes and industries. Commenters did not raise concerns regarding the standard's impact on competition and the Board has not identified any economic effects on competition.

### **Conclusion**

As discussed throughout this submission, and in the Board's adopting release, the Board believes that Auditing Standard No. 16 will contribute to audit effectiveness. In addition, the new standard should assist the audit committee in its oversight over financial reporting. Moreover, more effective and informed communications between the auditor and the audit committee also should help enhance the quality of a company's financial reporting.

In both its proposing and reproposing releases, the Board sought comment on all aspects of the standard and as part of the process specifically asked questions regarding the appropriateness of the standard for companies of all sizes or industries, which include EGCs. Commenters considered the requirements of the standard to be applicable and appropriate to companies of different sizes and industries. Notably, the Board received

comments from a wide spectrum of commenters, including from auditors that represented the interests of both small and large accounting firms and that audit companies of various sizes.

After the enactment of the JOBS Act, the Board compiled data available from entities voluntarily identifying themselves as EGCs in SEC filings. Based on data available to the Board, it appears that a wide range of entities, of differing sizes and industries, identify themselves as EGCs. One key difference between EGCs and other issuers appears to be the length of time that they have been subject to Exchange Act reporting requirements.

The Board believes that Auditing Standard No. 16 is in the public interest, and, for the reasons explained above, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the standard should apply to audits of EGCs. Accordingly, the Board requests that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply Auditing Standard No. 16 to audits of emerging growth companies. The Board stands ready to assist the Commission in considering any comments the Commission receives on these matters during the public comment process.

### III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Pursuant to Section 19(b)(2)(A)(ii) of the Exchange Act, and based on its determination that an extension of the period set forth in Section 19(b)(2)(A)(i) of the

Exchange Act is appropriate in light of the PCAOB's request that the Commission, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, determine that the proposed rule changes apply to audits of emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act, the Commission has determined to extend to [insert date 90 days from the date of publication in the Federal Register] as the date by which the Commission should take action on the proposed rule changes.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Sarbanes-Oxley Act.

In addition, the Board requested that the Commission, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, determine that the proposed rule changes apply to audits of emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act. In order for the proposed rule changes to apply to audits of emerging growth companies, the Commission must determine that the application is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation. Please provide any views you believe will help the Commission in making that determination.

Comments may be submitted by any of the following methods:

##### Electronic comments:

1. Use the Commission's Internet comment form

(<http://www.sec.gov/rules/pcaob.shtml>); or

2. Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number PCAOB-2012-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2012-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/pcaob/shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change; we do not edit personal identifying information from

submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB-2012-01 and should be submitted on or before [insert 21 days from publication in the Federal Register].

For the Commission, by the Office of the Chief Accountant, by delegated authority.<sup>185</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>185</sup> 17 CFR 200.30-11(b)(2).