Audit Committee *Brief*

Select a topic

Highlights from the AICPA's 2014 Conference on Current SEC and PCAOB Developments

Audit quality initiatives, internal control over financial reporting (ICFR), disclosure effectiveness, standard-setting initiatives, and IFRS were frequent topics of discussion at the 2014 AICPA conference, held December 8–10, 2014, in Washington, D.C. SEC staff and members of the PCAOB, FASB, and IASB provided updates on recent developments and offered a glimpse into their rulemaking and initiatives for the coming year.

This issue of the *Audit Committee Brief* highlights topics and insights from the conference that were particularly relevant to audit committees and provides links to additional resources for further information.

Audit quality initiatives

PCAOB Chairman James Doty emphasized the importance of high-quality, independent audits, referring to them as the "linchpin" of the financial markets. Doty indicated that while he believes that the auditing profession has a bright future, it must not take this period of relative calm for granted and give in to "temptations to scale back on doing what [a] good audit requires."

Working with audit committees

Doty and PCAOB Board Member Jay Hanson highlighted the PCAOB's continued efforts to engage with audit committees in support of their oversight of the auditors by equipping them with relevant and timely information about recent inspection findings, audit trends and risks, and other important audit quality topics.

A critical aspect of these efforts is the PCAOB's audit quality indicator (AQI) project, which is intended to establish a portfolio of quantitative measures of audit quality that audit committees can use to evaluate auditors. A concept release that will include a list of potential AQIs is expected to be issued in early 2015. In addition, the Center for Audit Quality issued a paper on audit quality indicators in April 2014 that is being field tested by audit firms with select audit committees. A key objective of both of these projects is to give audit committees valuable information about matters that contribute to an audit firm's delivery of a high-quality audit.

PCAOB inspections

As part of its plan to increase transparency and improve audit quality, the PCAOB expects to analyze the effectiveness and results of inspections and enhance the usefulness of its inspection reports.

At the conference, members of the PCAOB staff noted that although they have made progress internationally with inspections in many jurisdictions, they continue to work with their foreign counterparts to gain access to certain countries in order to increase transparency and investor protection. They said the PCAOB has identified deficiencies in approximately one-third of its inspections of prior-year audits that were referred to foreign auditors. Many of the deficiencies were associated with the testing of revenue and inventory, and the staff members indicated the PCAOB will increasingly focus on controls in a firm's global network.

Despite citing improvements in domestic inspections, the staff members said that they have continued to identify deficiencies associated with audits in areas such as revenue recognition, inventory, goodwill and intangible assets, and business combinations. In addition, they have identified deficiencies in auditors' testing of ICFR and management estimates.

SEC perspectives on audit quality

Deputy Chief Accountant Brian Croteau from the SEC's Office of the Chief Accountant (OCA) stressed the importance of auditor independence to auditors, management, and audit committees. Croteau noted that nonaudit services should be monitored to avoid "scope creep," and highlighted that scope creep can occur during the delivery of otherwise permissible nonaudit services when engagement activities deviate from the intended scope, impairing auditor independence. OCA staff members also emphasized that since audits of broker-dealers registered with the SEC must satisfy independence requirements under Regulation S-X, the auditor cannot both prepare and audit the broker-dealer's financial statements.

Internal control over financial reporting

Strengthening ICFR was a frequent theme at the conference. Staff members from the OCA questioned whether all material weaknesses in ICFR are being properly identified, evaluated, and disclosed. They attributed the inadequate identification and disclosure of material weaknesses to either not identifying deficiencies initially or not appropriately evaluating their severity.

The staff members also noted that understanding and accurately defining control deficiencies are critical to management's evaluation of their severity. They highlighted several factors that may help in understanding and describing a control deficiency, including the nature of the deficiency, its effect on financial reporting and ICFR, its cause, how it was identified, and the remediation procedures that will be performed.

The OCA staff members also discussed the identification of material weaknesses, noting that management appears to be focused on what happened (the actual error) rather than on what could happen (the "could factor") when evaluating the severity of deficiencies. They explained that such an evaluation requires management to consider the nature and amount of the transactions exposed to the deficiency, as well as the current and future volume of activity.

The OCA staff reminded management to identify and consider financial reporting risks in its annual ICFR evaluations, noting that it is critical to evaluate the nature and extent of any changes in the risks to reliable financial reporting.

Implementation of the 2013 COSO Framework

In a discussion regarding the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) updated 2013 Internal Control – Integrated Framework, the OCA staff expressed hope that the framework's enhanced organization and structure will lead to improved evaluation of the components outside of control activities. The staff members reminded participants that COSO will no longer support the 1992 Framework as of December 15, 2014, but indicated that they do not expect the SEC staff to immediately ask companies why they did not use the 2013 Framework. However, companies that have not transitioned may begin to receive questions (from, for example, the SEC's Division of Corporation Finance) as time passes about why they use an outdated framework. They also highlighted the importance of companies disclosing to investors which framework has been used.

Additionally, the OCA staff noted that the cause of a deficiency in the COSO Framework component related to control activities may indicate a deficiency in another COSO component, which may be overlooked if the cause is not appropriately understood. For example, a deficiency in the design of a control activity may indicate a deficiency in management's risk assessment, and a deficiency in the operating effectiveness of a control activity could suggest a deficiency in management's monitoring.

For more information on the 2013 COSO Framework, see Deloitte's September 5, 2014, and June 10, 2013, issues of *Heads Up*.

PCAOB perspectives on ICFR

Staff members of the PCAOB commented that ICFR continues to be a challenge for auditors in the current inspection cycle and discussed the most common findings related to internal controls. These include the failure to:

- Obtain a sufficient understanding of the flow of transactions to identify and test the controls that mitigate risks
- Test management review controls
- Test the completeness and accuracy of the data used in the performance of controls.

The staff also discussed other challenges, including testing fair-value measurements and management estimates, as well as not effectively responding to the assessed risk of material misstatement, particularly with respect to revenue.

The PCAOB staff members referred registrants to the PCAOB's Rule 4010 report (which provides observations from the PCAOB's inspection findings related to internal controls) and Staff Audit Practice Alert No. 11, Considerations for Audits of Internal Control over Financial Reporting.

Disclosure effectiveness

Several presenters at the conference expressed that registrants can strengthen their disclosures by emphasizing matters that are material and relevant, and deemphasizing or removing disclosures that are not.

Staff members from the SEC's Division of Corporation Finance recapped the activities planned for the SEC's disclosure effectiveness project[1], and said they were evaluating Regulations S-K and S-X for improvements and hoped to issue an initial concept release in the near future.

The division's staff members discussed how, in the absence of specific requirements, registrants can improve their disclosure documents in the near term and how they can better focus their disclosures on matters that are material and relevant to their operations, liquidity, and financial condition. They noted that whether disclosures are about critical accounting estimates, results of operations, or other matters, effective and compliant MD&A disclosures appropriately identify and explain material known trends and uncertainties. The staff cited material operations in Venezuela, recent updates to mortality tables, and decreasing oil and gas prices as examples of items that may represent material trends and uncertainties and thus warrant inclusion in the MD&A section.

The staff members also indicated that they would focus on proxy reporting in a later phase of the disclosure project. SEC Chief Accountant James Schnurr said that he has devoted significant time to audit committee reporting issues since assuming his role in October 2014, and that the "[Office of the Chief Accountant] staff has been working closely with staff from [the division] and others throughout the commission to consider [the SEC's] existing disclosure requirements, current audit committee disclosure practices, and publicly available observations and commentary."

Disclosure materiality

The OCA staff discussed the "all-in" and "piecemeal" approaches to evaluating the materiality of disclosures. Under the all-in approach, an entity would be in the scope of a FASB Accounting Standards Codification topic's disclosure requirements if the financial statement balances were material, and omitted disclosures would generally be considered errors. Under the piecemeal approach, an entity would consider disclosure requirements on a line-item basis, and if the entity concluded that a disclosure was immaterial, its decision not to make that disclosure would generally not be considered an error. The staff members indicated that no final conclusions have been reached regarding these approaches and that the staff will continue to analyze them.

See Deloitte's October 16, 2014, August 26, 2014, and March 20, 2014, issues of *Heads Up* for additional information about the SEC staff's disclosure effectiveness initiative.

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1 In December 2013, in a report provided under the JOBS Act, the Division of Corporation Finance indicated that the SEC would commence a broad effort to modernize and streamline its rules and regulations.

Areas of PCAOB focus in 2015

Staff members of the PCAOB noted that areas of enhanced focus in 2015 will include the following:

- Environmental risk, including environmental developments, which will have a significant effect on financial reporting risks
- M&A activity, including cash flow projections used to support valuations and controls related to business combinations
- Income taxes, including undistributed earnings and cash held overseas, and controls related to income tax accounting and disclosure
- Investment returns
- Falling oil prices
- Statements of cash flows
- Cybersecurity

Standard-setting initiatives

PCAOB

Increasing the quality of audits through effective standard setting remains a strong focus of the PCAOB. Board Member Jay Hanson and Chief Auditor and Director of Professional Standards Martin Baumann outlined recently completed, current, and upcoming standard-setting projects.

Updates were provided on two key proposed auditing standards of particular interest to audit committees, investors, and auditors:

- **Auditor's reporting model** – In August 2013, the PCAOB proposed revisions to the auditor's reporting model in response to investor demands for a more informative and meaningful auditor's report. The revisions would require auditors to include in their reports a discussion of "critical audit matters," often described as matters related to the audit that "keep the auditor up at night." After analyzing the comments received on this proposal, the PCAOB plans to repropose the standard in early 2015 to further define critical audit matters.
- **Improving transparency through disclosure of the engagement partner and certain other participants in the audit** – A supplement to this proposed standard is expected to be issued in the first quarter of 2015. The supplement would address the mechanics of the disclosure, with the goal of striking a balance between investors' need for information about the names of the engagement partner and other firms participating in the audit and auditors' concerns about increased liability.

Hanson also reported that the PCAOB's standard-setting program now explicitly incorporates economic analysis, which aims to weigh the benefits of meeting investors' and other stakeholders' needs against the costs to the audit. Eventually, the PCAOB expects to expand its economic analysis model to all its activities. See Deloitte's December 5, 2014, *Heads Up* for a full list of PCAOB projects and initiatives.

FASB

FASB Chairman Russell Golden stressed that the board's first priority is to improve U.S. GAAP; he emphasized the importance of reducing U.S. GAAP's complexity and referenced FASB's simplification initiative. He also highlighted the need for a complete conceptual framework to bridge gaps and minimize inconsistencies. These priorities have helped align the guidance of U.S. GAAP and IFRS on some topics (e.g., the measurement of inventory, development-stage enterprises, and extraordinary items), though at times the simplification of U.S. GAAP has resulted in conclusions different from those of the IASB on certain topics (e.g., leases, impairment, classification and measurement, and insurance). Consequently, the FASB continues "to collaborate and cooperate with the IASB and national standard-setters, with an eye toward agreeing on and adopting standards that either are converged or [have] the fewest possible differences."

In addition, Golden said that the FASB staff is researching an agenda project to address revenue recognition issues raised by the FASB/IASB joint Transition Research Group (TRG) that are related to intellectual property transactions, the determination of whether certain performance obligations are distinct in the context of the contract, and gross versus net presentation determinations. See Deloitte's November 4, 2014, *TRG Snapshot* for a more detailed discussion of the TRG's October 2014 meeting on revenue recognition issues.

For further information about the boards' current projects, refer to FASB's technical agenda and IASB's work plan.

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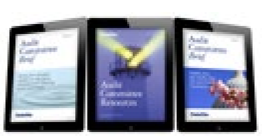

IFRS

The SEC has explored several alternatives for using IFRS in the United States, including adopting IFRS outright, giving U.S. registrants the option to switch to IFRS financial statements, and implementing a "condorsement" approach, where elements of convergence are combined with an endorsement process by the FASB.

In his comments at the conference, SEC Chief Accountant James Schnurr discussed an additional potential alternative: allowing U.S. companies to voluntarily provide IFRS-prepared financial information as a supplement to U.S. GAAP financial statements. The information could range from selected IFRS financial information to full IFRS financial statements. Schnurr noted that "[u]nder this line of thinking, issuers that do not believe IFRS-based information would be beneficial to investors would not be forced to undertake what we understand to be, in some cases, significant implementation costs."

Schnurr said that the goal of providing investors with consistent, high-quality information remains paramount and recognized that "any continued uncertainty around IFRS results in uneasiness for investors across the globe. Therefore, it is a priority to bring a recommendation to the commission in the near future with the hope of resolving, or at least lessening, this uncertainty."

Conclusion

Regulators and standard-setters continue to emphasize the central role that the audit committee plays in the financial reporting and auditing process. There was a strong focus at the conference on topics related to enhancing the fundamentals of accounting and auditing, including audit quality indicators, ICFR, and disclosures. The audit committee is both directly affected by, and can directly influence, outcomes in these areas. The conference provided insights into where regulators will likely be focusing their efforts in the coming months. Audit committee members can strengthen the effectiveness of their oversight by evaluating their organizations' preparation for and alignment with financial reporting regulatory developments.

Additional Deloitte resources

Heads Up, December 15, 2014: Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments

Heads Up, December 5, 2014: A Summary of the November 20-21 Meeting of the PCAOB's Standing Advisory Group

SEC Comment Letters – Including Industry Insights, November 20, 2014: A Recap of Recent Trends

TRG Snapshot, November 4, 2014: Joint Meeting on Revenue: October 2014

Heads Up, October 16, 2014: SEC Staff Suggests Ingredients for Effective Disclosures

Heads Up, September 5, 2014: Challenges and Leading Practices Related to Implementing COSO's "Internal Control – Integrated Framework"

Heads Up, August 26, 2014: The Road to Effective Disclosures

Heads Up, March 20, 2014: Highlights of the "SEC Speaks in 2014" Conference

Heads Up, June 10, 2013: COSO Enhances Its Internal Control – Integrated Framework