Audit Committee *Brief*

Select a topic

Highlights from the AICPA's 2013 Conference on Current SEC and PCAOB Developments

Disclosures, enforcement activities, audit quality, standard-setting, and auditor independence and objectivity figured prominently on the agenda of the 2013 AICPA National Conference on Current SEC and PCAOB Developments. The conference, held from December 9–11 in Washington, D.C., featured insights from regulatory leaders at the SEC, PCAOB, and other agencies, as well as discussion panels on accounting, reporting, and auditing issues.

Transparency and the quality of financial reporting, and their fundamental role in protecting investors, emerged as frequent themes. Numerous speakers tied their comments back to these themes in the context of improving disclosures in registrants' filings, evaluating internal controls, executing high-quality audits, developing standards that reduce complexity and increase clarity, and enhancing the usefulness of the information provided in the auditor's report.

This issue of the *Audit Committee Brief* highlights developments and insights from the conference that are of particular relevance to audit committee members, along with additional resources useful in addressing these issues.

Disclosures

SEC staff members outlined points to consider when assessing whether to provide disclosures in the MD&A and when determining the nature and extent of such disclosures. They highlighted the importance of:

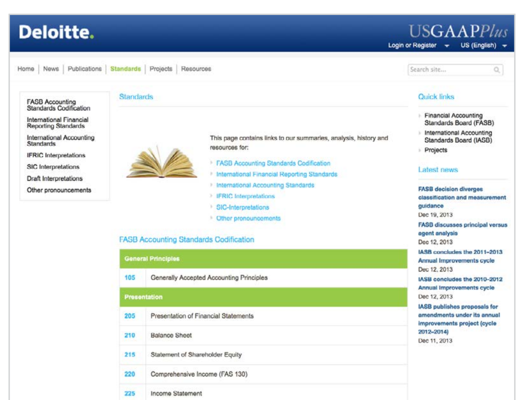
- Emphasizing material matters in disclosures, while reconsidering disclosures about immaterial matters that may lead to investors attaching undue significance to them.
- Clearly disclosing accounting policies, especially when there are alternatives under U.S. GAAP
- "Connecting the dots" to avoid inconsistent disclosures by considering interrelated disclosures within and outside filings
- Providing balanced disclosures and appropriate context for them
- Using precise terms that are defined in U.S. GAAP.

Echoing the remarks of SEC Chairman Mary Jo White about "disclosure overload," various members of the SEC staff reiterated that registrants should assess materiality when considering their disclosures, clarifying that the staff is not asking for more disclosure, but rather clearer, more precise, and transparent disclosures about material matters.

A summary of SEC staff comments on particular disclosure topics at the conference can be found in the December 16, 2013, *Heads Up*. For a detailed analysis of the disclosure trends identified in the SEC staff's recent comment letters, see Deloitte's SEC Comment Letters — Including Industry Insights: Constructing Clear Disclosures. This publication includes extracts of frequently issued SEC staff comments and links to resources relevant to SEC filers.

US GAAP *Plus* website

Deloitte's new US GAAP *Plus* website is a comprehensive source for news, publications, and project updates about U.S. and international accounting standard setting. It covers the activities of the FASB, IASB, PCAOB, AICPA, and SEC; the IFRS Interpretations Committee; and other U.S. and international accounting and auditing standard setters. The site contains a news page, an extensive library of U.S. and international Deloitte publications on accounting developments, and a list of active FASB projects and convergence projects with the IASB. It also features a customizable "My US GAAP Plus" view, which can be used to personalize your content and follow topics of particular interest or relevance. Access to the site is free to all users.



Enforcement activities

Andrew Ceresney, co-director of the SEC's Division of Enforcement, noted that there has been a reduction in the number of investigations related to financial reporting and auditing violations in fiscal year 2012 compared with fiscal years 2006 and 2007. He emphasized the division's renewed focus on financial reporting and audit violations and highlighted its creation of the Financial Reporting and Audit Task Force. Ceresney said that the division intends to carefully monitor compliance and focus on whether auditors missed or ignored red flags, had proper documentation, and followed professional and auditing standards.

Ceresney added that the division is particularly interested in looking for bad-faith estimates management makes about losses and reserves and "sham" revenue transactions, as well as auditors' procedures for testing management's estimates. He said that the division intends to keep an eye out for violations related to premature revenue recognition, the distortion of percentage of completion accounting, and sales inflation schemes, such as billing for uncompleted products through a "prebooking" scheme.

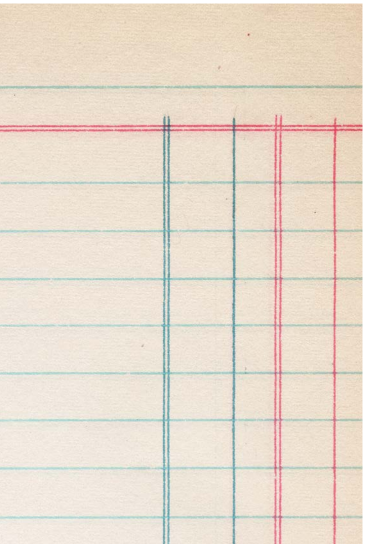
David Woodcock, enforcement regional director with the SEC's Division of Enforcement and chairman of the new task force, said that, in addition to focusing on technical accounting fraud, the division will focus on non-GAAP measures, omissions in MD&A, ICFR, and patterns and trends that could indicate increased risk. He discussed the sources that the division uses to identify violations, including tips, complaints, and referrals, as well as the monitoring of private litigation and media and analyst reports.

He said the division has received more than 3,000 whistleblower tips through the program, 17 percent of which were attributable to financial statement disclosures.

Kara Brockmeyer, chief of the SEC's Foreign Corrupt Practices Act Unit, emphasized that entities must maintain sufficient internal control over compliance with the Foreign Corrupt Practices Act and ensure that controls are operating effectively and cannot be circumvented. She said that entities should pay particular attention to transactions involving gifts, travel and entertainment, and third-party intermediaries. Brockmeyer highlighted the value of an effective anonymous internal reporting mechanism (i.e., a whistleblower program), because it allows management to identify potential issues before they become significant problems.

The audit committee's role in auditor selection

Paul Beswick, the SEC's chief accountant from the Office of the Chief Accountant, discussed the importance of considering audit quality in deciding whether to hire or retain an auditor, and said he hoped that audit committees would not always choose the lowest-cost provider. He noted that focusing on audit quality is consistent with making sound business decisions and that the committee's decision should focus on which auditor will best protect the interests of shareholders. Beswick cautioned registrants that "if the audit committee is solely fee hunting and if there was a subsequent audit failure, beyond the obvious problems for the auditor and the company, this may raise questions about the diligence of the members of the audit committee in fulfilling their responsibilities."



Auditor independence and objectivity

Audit committee and management independence considerations

Brian Croteau, the SEC's deputy chief accountant, emphasized the importance of auditor independence and stressed that audit committees and management are as responsible as auditors for monitoring and maintaining independence. In particular, he noted that audit committees and management should establish processes and procedures for the timely identification of the registrant's affiliates and consider potential independence issues that may arise due to auditor changes. This could include, for example, confirming that the registrant can find an independent auditor in a jurisdiction in which mandatory auditor rotation is required, or maintaining a predecessor auditor's independence to avoid the need for a reaudit in case there is a need to restate the registrant's financial statements in the future.

Expansion of firms' consulting services

The PCAOB plans to investigate the effect of the expansion of firms' consulting services on audit quality and auditor independence. Issues to be studied include risks associated with consulting service lines and how they affect resource allocation and investment in audit, as well as the ability of firm management to meet the compensation and cultural challenges that such services present. The board plans to hold roundtables in 2014 to explore the issue with firm leaders and other stakeholders. Beswick expressed concern that audit firms' efforts to expand their consulting practices in recent years could undermine investors' perceptions of auditor independence. He said that independence concerns are not limited to the United States, but have been raised around the globe.

The revised COSO Framework

During a panel discussion, it was suggested that companies should educate themselves about the revised 2013 COSO Framework and conduct a preliminary assessment by mapping their controls to the 17 principles in the updated framework, taking into account the framework's "points of focus." The panelists noted that this mapping exercise will not only support management's assertion under SEC regulations but may also reveal "gaps" in design, particularly those associated with the softer components of ICFR, such as the control environment, risk assessment, information, and communication and monitoring, as well as opportunities to redesign or remove controls to enhance effectiveness and efficiency. The panelists suggested that management should meet regularly with the auditors to hear their perspectives on management's strategy for transitioning to the 2013 framework, and to understand any changes that may be needed in documentation or audit procedures.

Although COSO does not have authority as a standard setter, the panelists encouraged companies to begin their transition of applications and related documentation to the 2013 framework as soon as feasible, and they noted that during the transition period, external reporting should disclose whether the original or 2013 framework was used. For more information on the 2013 framework, see Deloitte's June 10, 2013, issue of *Heads Up*.

Audit quality indicator project

The audit quality indicator (AQI) project allows the PCAOB to develop a portfolio of quantitative measures to identify audit quality and provide information to the public that further promotes audit quality. Greg Jonas, director of research and analysis for the PCAOB, said that AQIs are expected to lead to improved dialogue between auditors and investors and promote competition among auditors regarding audit quality. The PCAOB expects to issue a concept release in early 2014 that will include a list of 20 to 30 potential AQIs. Examples of these AQIs include the ratio of partners to staff; staff utilization; and results of audit committee surveys. For more information on this project, see Deloitte's June 25, 2013, and December 10, 2013, issues of *Heads Up*.

Conflict minerals reporting

Panelists highlighted aspects of the audit requirements associated with the SEC's conflict minerals rule. They noted that the rule involves expressing an opinion or concluding on (1) whether the design of the issuer's due diligence measures as set forth in the Conflict Minerals Report (CMR) conforms with, in all material respects, the due diligence framework used by the issuer, and (2) whether the issuer's description of the due diligence measures it performed, as set forth in the CMR, is consistent with the due diligence process the issuer undertook.

The auditor's responsibility does not extend to reaching a conclusion on whether the due diligence measures undertaken were in accordance with the framework, or on the accuracy of the company's determination of whether conflict minerals are "DRC conflict-free" or "are not found to be DRC conflict-free." Consequently, panelists reminded registrants to carefully consider how much "other" information to include in the CMR, and said that any such information should be factually correct and understandable.

Auditing and PCAOB developments

PCAOB Chairman James Doty highlighted recent developments at the board and provided insight into what stakeholders can expect. The board has been closely examining how it serves the capital markets for the investing public. Accordingly, it has undertaken initiatives aimed at dispelling the notion held by some that audits are irrelevant to investors and lenders and raising awareness that audits are critical to the nation's economic success and investor confidence. The board has also increased its focus on outreach, particularly to audit committees.

The PCAOB's board members and staff said that they had reexamined the inspection and reporting process and made refinements that have yielded more timely and informative inspection reports. They focused on three priorities: (1) the timeliness and content of inspection reports; (2) analysis of inspection findings among firms and over time; and (3) remediation, including the timeliness of remediation determinations. They noted that the PCAOB takes a risk-based approach to selecting audit engagements for inspection and identifies high-risk areas on which inspection teams should focus. The board members also discussed their findings from the 2013 inspection cycle, the most common of which related to internal controls, management estimates, and responses to risks of material misstatement.

Another important PCAOB development in 2013 was its launch of the Center for Economic Analysis. Led by economist Luigi Zingales, the center will study the role and relevance of the audit in capital formation and investor protection. It will also advise the PCAOB on how the board can make better use of economic theory, analysis, and tools to enhance its effectiveness in standard setting, inspections, and other oversight activities. The center is expected to begin operations in early 2014.

Standard-setting update

Increasing the quality of audits through more effective standard setting remains a strong focus of the PCAOB. The following standards were discussed by members of the PCAOB at the conference.

Proposed standards related to the auditor's report: Martin Baumann, PCAOB chief auditor and director of professional standards, noted that while investors value audits, the audit report itself provides them with limited information, and investors want to hear more from auditors about their work and findings. To address this concern, two proposed auditing standards related to the auditor's reporting model were released by the board in August 2013. The proposals would require the auditor to report on critical audit matters, auditor independence, auditor tenure, and the auditor's responsibility for, and results of, the evaluation of information outside the financial statements. For more information on the proposed model, see Deloitte's September 5, 2013, *Heads Up*.

Reproposed standard on transparency: The PCAOB issued a reproposed standard on auditor transparency in December 2013 that would require audit firms to disclose the name of the engagement partner as well as the names, locations, and extent of involvement of other audit firms providing more than 5 percent of total audit hours on an engagement. At the conference, Chairman Doty remarked that disclosure of the engagement partner's name would sharpen the minds of the auditors and remind them of their responsibility to the public. He added that such disclosure will provide meaningful information for audit committees when assessing an engagement partner's qualifications and experience.

Broker-dealer attestation standards: The PCAOB adopted two attestation standards in October 2013 that apply to examination engagements related to compliance reports of broker-dealers, as well as review engagements related to exemption reports of broker-dealers under Rule 17a-5 of the Exchange Act. The same day, the PCAOB issued Auditing Standard No. 17, which requires auditors to perform certain audit procedures when reporting on supplemental information such as that filed by broker-dealers under Rule 17a-5.

Reproposed standard on related-party transactions: The PCAOB expects to issue a reproposed auditing standard on related parties as part of a release in the first quarter of 2014 to strengthen auditor performance in three critical areas: (1) relationships and transactions with related parties; (2) significant unusual transactions; and (3) financial relationships and transactions with executive officers. Aimed at reducing fraudulent activities, audit deficiencies, and inconsistent audit practices associated with related-party transactions, the reproposed standard introduces new procedures while maintaining and strengthening procedures already used by many auditors. For more information, see Deloitte's June 21, 2013, *Heads Up*.

Other near-term standard-setting activities: Baumann highlighted other standard-setting activities that the PCAOB will address in the near term:

- **Going concern –** The PCAOB's project to improve going-concern evaluation requirements has been delayed until the FASB determines a timeline for revising its own proposed standard on the topic.

- **Auditors' responsibilities with respect to other accounting firms, individual accountants, and specialists –** This proposal is intended to improve planning, supervision, and communication when outside parties participate in an audit. The PCAOB expects to issue a proposed standard in the first quarter of 2014.
- **Auditing accounting estimates, including fair-value measurements –** The PCAOB will propose a standard on auditing accounting estimates, including fair-value measurements, to replace a number of its interim auditing standards. The PCAOB expects to issue the proposal in late 2014.
- **Audit firm quality control system –** The PCAOB plans to issue a concept release seeking comments on how to address audit firm quality control issues. Baumann said that current quality control standards do not appropriately address various matters that are important to audit quality, including the tone at the top, the risk assessment and response to risk, accountability and supervisory activities by firm management, professional skepticism, the alignment of individual incentives, and remediation and root-cause analyses.
- **Proposed reorganization of PCAOB audit standards –** The PCAOB has proposed reorganizing its auditing standards to structure them more logically and to integrate the board's interim standards with the standards issued since its inception. Doty expects the board to complete the reorganization in 2014.

Further information on the PCAOB's standard-setting agenda can be found in Deloitte's December 10, 2013, *Heads Up*.

Conclusion

The SEC and PCAOB's continued focus on investor protection underscores the importance of the audit committee's role in confirming that auditing and reporting activities keep investors' best interests in mind. The audit committee is well positioned to determine whether management's disclosures are framed clearly and that the information needed by shareholders is conveyed appropriately. As the comments from the SEC staff at the conference indicate, the focus is not always on more disclosure, but on more appropriately targeted and relevant material disclosures. In addition, the PCAOB continues to focus on enhancing its outreach to audit committee members, and the feedback of committee members will be important as numerous initiatives, such as those related to the auditor's reporting model and audit quality indicators, are contemplated.

Additional resources

December 16, 2013, *Heads Up*: Accounting in a Winter Wonderland: Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments

December 5, 2013, *Heads Up*: SEC Comment Letters—Including Industry Insights: Constructing Clear Disclosures

June 10, 2013, *Heads Up*: COSO Enhances its Internal Control—Integrated Framework

June 25, 2013, *Heads Up*: A Summary of the May 15–16 Meeting of the PCAOB's Standing Advisory Group

December 10, 2013, *Heads Up*: A Summary of the November 13–14 Meeting of the PCAOB's Standing Advisory Group

September 5, 2013, *Heads Up*: PCAOB Proposes Changes to the Auditor's Reporting Model and the Auditor's Responsibilities regarding Other Information

June 21, 2013, *Heads Up*: PCAOB Reproposes New Auditing Requirements on Related Parties, Significant Unusual Transactions, and Other Matters

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