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BDO BOARD REFLECTIONS

COMMUNICATIONS WITH AUDIT COMMITTEES – OVERVIEW OF PCAOB AUDITING STANDARD NO. 16

In August 2012, the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard (AS) No. 16, *Communications with Audit Committees*. The PCAOB believes its adoption is in the public interest as it establishes requirements that enhance the relevance, timeliness and quality of the communications between the auditor and the Audit Committee, while also better aligning with the requirements of the Sarbanes-Oxley Act of 2002 to facilitate Audit Committees' financial reporting oversight. AS 16 largely retains previous guidance and does not impose any new performance requirements (i.e., auditing procedures) on the auditor. Rather, it expands and/or enhances current communication requirements between the auditor and the Audit Committee to align and complement auditing procedures already required by other PCAOB audit and risk assessment standards.

In December 2012, the SEC approved AS 16 and additionally determined the standard and related amendments will apply to audits of (1) public companies, (2) emerging growth companies (EGCs) under the Jumpstart Our Business Startups Act of 2012, (3) foreign private issuers (FPIs), and (4) non-issuer brokers and dealers registered with the SEC, at such time as the SEC determines to make the PCAOB standards applicable to such audits of brokers and dealers.[1]

1 The SEC has proposed requiring application of PCAOB standards for audits of brokers and dealers in its June 2011 Release 34-64676 available at: http://www.sec.gov/rules/proposed/2011/34-64676.pdf.

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AS 16 is effective for public company audits of fiscal periods beginning on or after December 15, 2012, and early adoption is permitted.

The PCAOB's AS 16 Release No. 2012-004 document may be accessed at: *http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf*. Note: The Release includes the Additional Discussion information contained within Appendix 4 that is not included in the Table of Contents on the PCAOB's final AS 16 standard page at: *http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_16.aspx*.

The SEC's order granting approval of AS 16 may be accessed at: *http://www.sec.gov/rules/pcaob/2012/34-68453.pdf*.

GENERAL PROVISIONS OF AS 16 WORTH NOTING:

- **Definition of an Audit Committee:** AS 16's definition of an Audit Committee is largely consistent with the definition found within the Sarbanes-Oxley Act of 2002 as it relates to issuers. AS 16 also provides that for audits of nonissuers,[2] such as registered brokers and dealers, if no such committee or Board of Directors (or equivalent body) exists with respect to the company, the auditor should communicate the requirements of AS 16 with the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

- **Timeliness:** Required communications must be made 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 matters communicated.

- **Responsibility with respect to management communications:** In certain circumstances, management might communicate to the Audit Committee matters related to the company's financial statements that are required communications by the auditor under AS 16. The auditor does not need to communicate those matters at the same level of detail as long as the auditor:
  - participated in management's discussion with the Audit Committee
  - affirmed to the Audit Committee that management's communication was adequate
  - with respect to critical accounting policies and practices, identified those that the auditor considered critical

The auditor should also communicate any omitted or inadequately described matters to the Audit Committee.

- **Scalability:** Based on the company's circumstances, AS 16 requires communications only to the extent that the matters are *relevant* to the audit of the financial statements of the company or to the audit 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.

- **Incorporation of other rules and standards:** AS 16 incorporates certain SEC auditor communication requirements to Audit Committees and provides a comprehensive reference to additional communication requirements by other PCAOB standards.

- **Oral vs. written communications:** Unless otherwise specified within AS 16 or other PCAOB standards, the communications may be made orally or in writing. Auditors must document the communications in the working papers including whether such communications took place orally or in writing. Working paper 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 AS 16.

- **Interim reviews:** AS 16 is effective for quarterly reviews of fiscal years beginning on or after December 15, 2012. When conducting a review of interim financial information, the auditor should determine whether any of the matters described in AS 16, as they relate to interim information, have been identified. The PCAOB amended AU 722, *Interim Financial Information*, to indicate that any communication the auditor 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 auditor considered when conducting the review of interim financial information. The amendments to AU 722 do not require that the interim communications repeat the annual communications but, rather, that the communications be related to the auditor's findings while performing the interim review procedures.

2 AS 16 recognizes 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 non-issuer 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.

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▶AS 16 REQUIRED COMMUNICATIONS:

The following table highlights the specific communication requirements outlined in AS 16, along with BDO's insight regarding changes to current practice.

Communication Requirement	BDO Insight: Changes in Practice
Establish an understanding of the terms of the audit engagement	While it has been common practice to do this via engagement letters, AS 16 now specifically requires an annual, mutual understanding between the auditor and the Audit Committee in an engagement letter and for the Audit Committee to acknowledge and agree to the terms of the engagement. Such acknowledgement can be written (e.g., the engagement letter signed by an Audit Committee member or via Audit Committee meeting minutes) or oral. If the Audit Committee's acknowledgement is received orally, AS 16 requires the auditor to document the acknowledgement in the working papers. Terms of the audit include the objective of the audit, the responsibilities of the auditor and the responsibilities of management.
Significant issues discussed with management in connection with appointment or retention	AS 16 is consistent with current requirements and requires discussion with the Audit Committee of any significant issues the auditor discussed with management in connection with his/her appointment or retention, including significant discussions regarding the application of accounting principles and auditing standards.
Obtain information from the Audit Committee relevant to the audit	AS 16 explicitly requires the auditor to make inquiries of the Audit Committee about matters of relevance to the audit. Such discussions and inquiries were likely common practice but are now specifically required under AS 16, highlighting that such discussions include, but are not limited to, violations or possible violations of laws or regulations; risk of material misstatements, including fraud risks; and tips or complaints regarding the company's financial reporting.
Overall audit strategy, timing of the audit, and significant risks identified[3]	While it has been common practice to hold such discussions, this was not a specific requirement for public companies prior to AS 16. AS 16 requires enhanced and specific discussions in this area, as outlined below.
If applicable, nature and extent of specialized skills or knowledge needed related to significant risks	While it has been common practice to hold such discussions, this was not a specific requirement prior to AS 16. AS 16 requires enhanced and specific discussions, if applicable, regarding the nature and extent of specialized skills or knowledge needed to perform the planned audit procedures or evaluate audit results related to significant risks. The focus of this requirement is on the communication about the need for specialized skills or knowledge, regardless of whether the specialist is from within the audit firm or outside the firm.
If applicable, extent to which the auditor plans to use the work of others and the basis for the auditor's determination that he/she can serve as the principal auditor	While it has been common practice to hold such discussions, this was not a specific requirement prior to AS 16. AS 16 requires enhanced and specific discussions, if applicable, regarding the extent to which the auditor plans to use the work of others and the basis for the auditor's determination that he/she can serve as the principal auditor. This would include: (1) plans to use the work of the company's internal auditors in an audit of financial statements (2) plans to use the work of the company's internal auditors, other company personnel and third parties working under the direction of company management or the Audit Committee when performing an audit of internal control over financial reporting (3) the names, locations and planned responsibilities of other independent public accounting firms (including network member firms) or others, who are not employed by the auditor, that perform audit procedures in the current audit period (4) the basis for the auditor's determination that he/she can serve as the principal auditor, if significant parts of the audit are to be performed by other auditors

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

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Communication Requirement	BDO Insight: Changes in Practice
Significant changes to planned audit strategy or significant risks initially identified	While it has been common practice to hold such discussions, this was not a specific requirement prior to AS 16. AS 16 requires enhanced and specific discussions for significant changes to the planned audit strategy or significant risks initially identified and previously communicated to the Audit Committee, and the reasons for such changes.
Significant accounting policies and practices	AS 16 substantively carries forward existing requirements but differentiates between "significant" and "critical." "Significant accounting policies and practices" involve a broader range of matters/issues over time and are based upon the FASB and IASB definition. Communication requirements include (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.
Critical accounting policies and practices	As noted above, AS 16 substantively carries forward existing requirements but differentiates between "significant" and "critical." "Critical accounting policies and practices" is defined based on the SEC's description of the term and 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. Critical accounting policies and practices would therefore be considered a component of significant accounting policies and procedures. Communication requirements under AS 16 are consistent with current SEC requirements under SEC Regulation S-X, Rule 2-07, and include (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.
Critical accounting estimates	AS 16 defines critical accounting estimates in line with the SEC's interpretative guidance in connection with Management's Discussion and Analysis (MD&A). A "critical accounting estimate" is 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. AS 16 carries forward existing communication requirements and enhances these to specifically include (1) a description of the process management used to develop critical accounting estimates, and (2) management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity. It further outlines a new requirement related to communicating any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, reasons for the changes, and the effects of the changes on the financial statements.
Significant unusual transactions	AS 16 emphasizes enhanced required communications regarding significant unusual 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 the policies and practices management used to account for such transactions. As part of this communication, the auditor describes his/her understanding of the business rationale for these types of transactions.

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Communication Requirement	BDO Insight: Changes in Practice
Auditor's evaluation of the quality of the company's financial reporting[4]	AS 16 is very similar to current required communications regarding the quality of the company's financial reporting but further emphasizes enhanced communications which are required to include: (1) the qualitative aspects of significant accounting policies and practices, including the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including any situations of bias in management's judgment about the amounts and disclosures in the financial statements identified by the auditor; and 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 management (2) the auditor's assessment of critical accounting policies and practices and related disclosures, including any significant modifications proposed by the auditor to the disclosures that management did not make (3) conclusions regarding the reasonableness of critical accounting estimates, including the basis for the auditor's conclusions (4) the auditor's understanding of the business rationale for any significant unusual transactions (5) the auditor's evaluation of the presentation of the financial statements and related disclosures in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement and content of the financial statements (including accompanying notes), encompassing matters such as terminology used, the amount of detail given, the classification of items and the bases of amounts set forth (6) any concerns identified by the auditor relating to anticipated application by management of new accounting pronouncements issued but not yet effective that may have a significant effect on future financial reporting (7) any alternative accounting treatments 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, if applicable
Difficult or contentious matters for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the Audit Committee's oversight of the financial reporting process	This is a new requirement under AS 16 Appendix 4 – Additional Discussion, section X, contained within the PCAOB's final AS 16 rule Release No. 2012-004 further defines what constitutes "difficult or contentious" matters. It is important to note that AS 16's communication requirements include consultations on difficult or contentious matters that involve the engagement quality reviewer, as the PCAOB's emphasis is on communications concerning the content rather than focusing on the parties involved in the consultation. The PCAOB's Release is available at: *http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf*.
Management consultations with other accountants	AS 16 carries forward current guidance relating to management's consultation with other accountants about significant auditing or accounting matters; however, AS 16 indicates that communication is required only when the auditor has identified a concern.
Corrected misstatements related to accounts and disclosures, other than those that are clearly trivial, brought to the attention of management by the auditor	AS 16 carries forward existing requirements and enhances such discussions such that the auditor is required to communicate corrected misstatements, other than those that are clearly trivial, (in contrast to communicating corrected misstatements that have a "significant effect") related to accounts and disclosures that might not have been detected except through auditing procedures performed, as well as the implications these may have on the financial reporting process.

4 Refer to AS 16 paragraph 13 and related footnotes for further guidance on communications regarding the quality of the company's financial reporting and respective related auditing guidance.

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Communication Requirement	BDO Insight: Changes in Practice
Uncorrected misstatements related to accounts and disclosures, other than those the auditor believes to be trivial	AS 16 carries forward existing requirements and enhances such discussions such that the auditor is required to communicate the basis for determination, including the qualitative factors, that the uncorrected misstatements related to accounts and disclosures were immaterial. The auditor is also required to 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.
Other information in documents containing the company's audited financial statements	AS 16 carries forward existing guidance related to other information that is presented in documents containing audited financial statements. In those circumstances, the auditor's responsibility does not extend beyond the financial information identified in the auditor's report, and there is no obligation to perform any procedures to corroborate other information contained in a document. However, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with its presentation within the financial statements. The auditor's responsibility also includes calling to management's and the Audit Committee's attention any information that he/she believes is a material misstatement of fact.
Disagreements with management[5]	AS 16 carries forward existing guidance related to 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.
Significant difficulties encountered during the audit[6]	Consistent with existing standards, AS 16 specifically requires the auditor to communicate significant difficulties encountered when performing the audit which include but are not limited to: (1) 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 (2) An unreasonably brief time within which to complete the audit (3) Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence (4) Unreasonable management restrictions encountered by the auditor on the conduct of the audit (5) 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
If applicable, auditor's evaluation of the company's ability to continue as a going concern	When applicable, it is common practice to communicate going concern matters to the Audit Committee. However, prior to AS 16 such communications were technically not required. AS 16 now specifically requires, when applicable, that the auditor communicate the following: (1) 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 the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt about the company's ability to continue as a going concern; and (2) if, after considering management's plans, the auditor concludes the going concern uncertainty is alleviated, the basis for such conclusion (which includes the elements of management's plans that the auditor considers significant to overcoming the adverse effects of the conditions or events) or (3) if, after considering management's plans, the auditor concludes there is substantial doubt about the company's ability to continue as a going concern, the effects, if any, on the financial statements and adequacy of disclosure and the effects on the auditor's report.

5 Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining relevant facts or information prior to the issuance of the auditor's report.

6 Difficulties encountered by the auditor during the audit could represent a scope limitation, which may result in the need for the auditor to modify the auditor's opinion or withdraw from the engagement.

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Communication Requirement	BDO Insight: Changes in Practice
Fraud and potential illegal acts involving senior management and those that cause a material misstatement of the financial statements	Required by other standards – PCAOB AU 316, *Consideration of Fraud in a Financial Statement Audit,* and PCAOB AU 317, *Illegal Acts by Clients*
Other material written communications with management	AS 16 carries forward the communication requirements in SEC Regulation S-X, Rule 2-07, regarding material written communications between the auditor and management.
If applicable, departure from auditor's standard report	While it is common practice for the auditor to communicate to the Audit Committee any departures from the auditor's standard report, AS 16 specifically requires the auditor to communicate when he/she expects to modify the opinion and/or include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the departure, and the wording to be used.
Other matters significant to the oversight of the company's financial reporting process	AS 16 carries forward existing guidance in this area and includes communications such as 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.

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