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PCAOB Update – Audit Considerations in the Current Environment

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PCAOB

Public Company Accounting Oversight Board

Disclaimer

The views expressed are those of the speaker alone and do not necessarily reflect the views of the Board, its members or staff.

Topics

- Overview
    - Introduction
    - PCAOB Overview
    - Standards Update
    - Office of Research and Analysis
        - Surveillance methodologies
        - Peer reviewed research
- Emerging Risk in the Coming Year (s)
    - The “GAAP Tsunami”
        - The role of judgment/discretion

PCAOB Overview

- Board
- Standards
- Enforcement
- Registration and Inspections
- Research and Analysis

United States Supreme Court

- The plaintiff “won” the case;
- The process by which PCAOB board members were to be removed violated the Appointments Clause of the US Constitution
- The Supreme Court simply removed the words “for cause” from the Board removal provisions of SOX
- Result: PCAOB board members now serve at the pleasure of the SEC commissioners (and can be removed at whim)
- The remainder of SOX is totally unaffected, PCAOB remains fully operational

Update on Standards

- Recent Board Actions
  - Auditing Standard No. 7 - *Engagement Quality Review*
  - Proposed Auditing Standards - *The Auditor's Assessment of and Response to Risk*
  - Proposed Auditing Standard - *Communications with Audit Committees*
  - Proposed Auditing Standard - *Confirmation*
- Guidance
  - Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*
  - Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm*
- Other Standard-Setting Activities
- Standing Advisory Group

AS No. 7 – Engagement Quality Review

- Supersedes existing requirements for concurring reviews (former SEC Practice Section requirement §1000.08(f) and Appendix E)
- Applies to all registered firms
  - Firms that were not members of the AICPA SEC Practice Section as of April 16, 2003 were not required to perform concurring reviews
  - Under AS No. 7, all registered firms conducting audits in accordance with PCAOB standards are required to perform an EQR
- Available through PCAOB website at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_7.aspx

AS No. 7 – Engagement Quality Review

- Requires EQR for audits and interim reviews conducted pursuant to the standards of the PCAOB (AS 7.1)
  - Tailored requirements for the EQR of audits (AS 7.9-.13) and the EQR of interim reviews (AS 7.14-.18)
- Requires concurring approval of issuance prior to granting permission to the client to use the engagement report (AS 7.13, and .18)

AS No. 7 – Engagement Quality Review

- AS No. 7 is applicable for both the EQR of audits and the EQR of interim reviews for fiscal years beginning on or after December 15, 2009
  - Calendar year-end companies
    - Interim reviews for March 31, 2010
    - Audits for December 31, 2010
  - June 30 year-end companies
    - Interim reviews for September 30, 2010
    - Audits for June 30, 2011

Staff Question and Answer Auditing Standard No. 7, *Engagement Quality Review*

- Staff Q&A issued on February 19, 2010
- Addresses one question –
  - Question – Does the standard require documentation of all of the interactions between the EQR and the engagement team, including all of the interactions before a matter is identified as a significant engagement deficiency?
  - Answer – No. The example on page 21 of the adopting release illustrates how the documentation requirements of AS No. 7 should be applied once a reviewer concludes that a significant engagement deficiency exists.
- Available through PCAOB website at http://pcaobus.org/Standards/QandA/2010-02-19_EQR_QA%20_2.pdf

Risk Assessment

- Reproposed December 17, 2009
- Comment period ended on March 2, 2010
- Twenty-three comment letters received
- Available through PCAOB website at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx

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Risk Assessment

Significant changes to reproposed standards from original proposal:

- Alignment with Auditing Standard No. 5
  - Incorporates the requirements from AS No. 5 related to identifying and assessing risks of material misstatement that also apply to financial statement audits.
  - Excludes requirements related only to the audit of internal control over financial reporting.
- Emphasis on the consideration of fraud
  - Emphasizes that assessing and responding to risk of fraud is an integral part of an audit.
  - Incorporates the requirements for identifying and responding to risks of material misstatement due to fraud and evaluating audit results from AU sec. 316
- Enhancing the requirements for evaluating disclosures

Risk Assessment

- Seven new standards:
  - Audit Risk
  - Audit Planning and Supervision
  - Consideration of Materiality in Planning and Performing an Audit
  - Identifying and Assessing Risks of Material Misstatement
  - The Auditor's Responses to the Risks of Material Misstatement
  - Evaluating Audit Results
  - Audit Evidence

Communications With Audit Committees

- Board issued proposed standard on March 29, 2010; comment period ended on May 28, 2010
- Proposed standard available at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx
- Primary objectives of the proposed standard are to:
  - Enhance the relevance and effectiveness of communications between the auditor and the audit committee
  - Emphasize the importance of effective, two-way communications between the auditor and the audit committee

Communications With Audit Committees

- Retains the requirements from AU sec. 380, *Communication with Audit Committees*
- Adapts requirements from AU sec. 310, *Appointment of the Independent Auditor*
- Includes SEC-required communications for accounting-related matters

Communications With Audit Committees

- Adds a requirement to communicate an overview of audit strategy and timing of the audit
- Enhances communications regarding accounting policies, practices and estimates
- Changes requirements regarding timing of communications
- Requires a written engagement letter
- Adds a requirement to evaluate the adequacy of the two-way communication process

Confirmation

- Board issued proposed standard on July 13, 2010; comment period ends on September 13, 2010
- Proposed standard available at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx
- Primary objective of the auditor is to:
  - Obtain relevant and reliable audit evidence when designing and performing confirmation procedures

Confirmation

- Requires confirmation procedures for specific accounts
- Enhances requirements for confirmation procedures
- Reflect changes in technology

Confirmation

- Requires confirmation procedures
  - For receivables that arise from credit sales, loans, and other transactions
  - For cash and other relationships with financial institutions
  - In response to significant risks that relate to relevant assertion that can be adequately addressed by confirmation procedures

Confirmation

- Enhances requirements for confirmation procedures
  - Maintaining control over the confirmation process
    - Supplement negative confirmation requests with other substantive procedures
    - Determine that confirmation requests are properly addressed

Confirmation

- Enhances requirements for confirmation procedures (cont'd)
  - Evaluation
    - Perform appropriate alternative procedures for non-responses
    - Investigate exceptions in confirmation responses
    - Assess reliability of confirmation responses
      - Additional procedures for electronic confirmation responses
    - Evaluate disclaimers and restrictive language

Staff Audit Practice Alert No. 5

- Issued April 7, 2010
- The Alert reminds auditors of their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions
- Responsibilities described in the Alert include –
  - Identifying and assessing risks of material misstatement
  - Responding to risks of material misstatement
  - Consulting others
  - Evaluating financial statement presentation and disclosure
  - Communicating with audit committees
  - Reviewing interim financial information
- Available through PCAOB website at http://pcaobus.org/Standards/Pages/Guidance.aspx

Staff Audit Practice Alert No. 6

- Issued July 12, 2010
- The practice alert reminds registered firms of their obligations when using the work of other firms or using assistants engaged from outside the firm.
  - Describes the circumstances under which the firm issuing the audit report may use the work and reports of another auditor.
  - Auditors who engage assistants from outside the firm are governed by the same standards regarding planning the audit and supervising assistants that apply when audit work is performed by assistants who are partners of, or employed by, the auditor's firm.
- Available through PCAOB website at http://pcaobus.org/Standards/Pages/Guidance.aspx

Other Standard-Setting Activities*

- Requiring the Engagement Partner to Sign the Audit Report **(Concept Release issued July 28, 2009)**
- Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise"
- Related Parties
- Specialists
- Fair Value Measurements and Other Accounting Estimates

* Activities subject to change based on emerging issues

Other Standard-Setting Activities*

- Principal Auditor
- Quality Controls Standards, Including Quality Controls Over the Work of Affiliated Firms
- Applicability of SECPS Requirements to all Registered Firms
- Going Concern
- Subsequent Events

*	Activities subject to change based on emerging issues

Keeping Current with Standard-Related Activities

- Our Web site – http://www.pcaobus.org/Standards/Pages/default.aspx
  - PCAOB standards and related rules, including interim standards
  - PCAOB proposed standards
  - Staff Questions and Answers
  - Staff Audit Practice Alerts
  - Standing Advisory Group
- Contact us at info@pcaobus.org
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site at

http://pcaobus.org/About/Pages/Subscribe.aspx

Office of Research and Analysis

- Business Intelligence
  - Data for surveillance and reporting
  - Quant Model
  - Peer-reviewed research
- Surveillance
  - IRA (Internal Risk Application)
  - Quant Model
  - Monitor
- Risk Policy
  - Strategy
  - Standards
  - Quality control

PCAOB Surveillance Programs

- Two components: Screening and Analysis
- Point of entry: Screening the “X” and “Y” Axes
  - X Axis = Issuer information
  - Y-Axis = Accounting Firm information
  - “Vendor” vs “Non-vendor” data
- IRA – “Internal Risk Application”
- Quant Model
- Both are dynamic applications
  - Continuous evolution
  - Continuous investment
  - The new EDW

Beyond the Screen: Analysis of Screen Results, Writeup and Scoring

- Evaluation of screen results
- Read and analyze SEC Filings (Forms 10-K, 10-Q)
- Read or listen to earnings calls
- Other research
- Securities analysis
- Write referral?
- Scoring
- Pass to Inspectors

Performance Measurement

- “Negative Events”
  - Restatements
  - Litigation
  - SEC investigations
- PCAOB Inspection Comments
- Risk-based vs representative selection
- Top 120

Historical Performance – All Selections

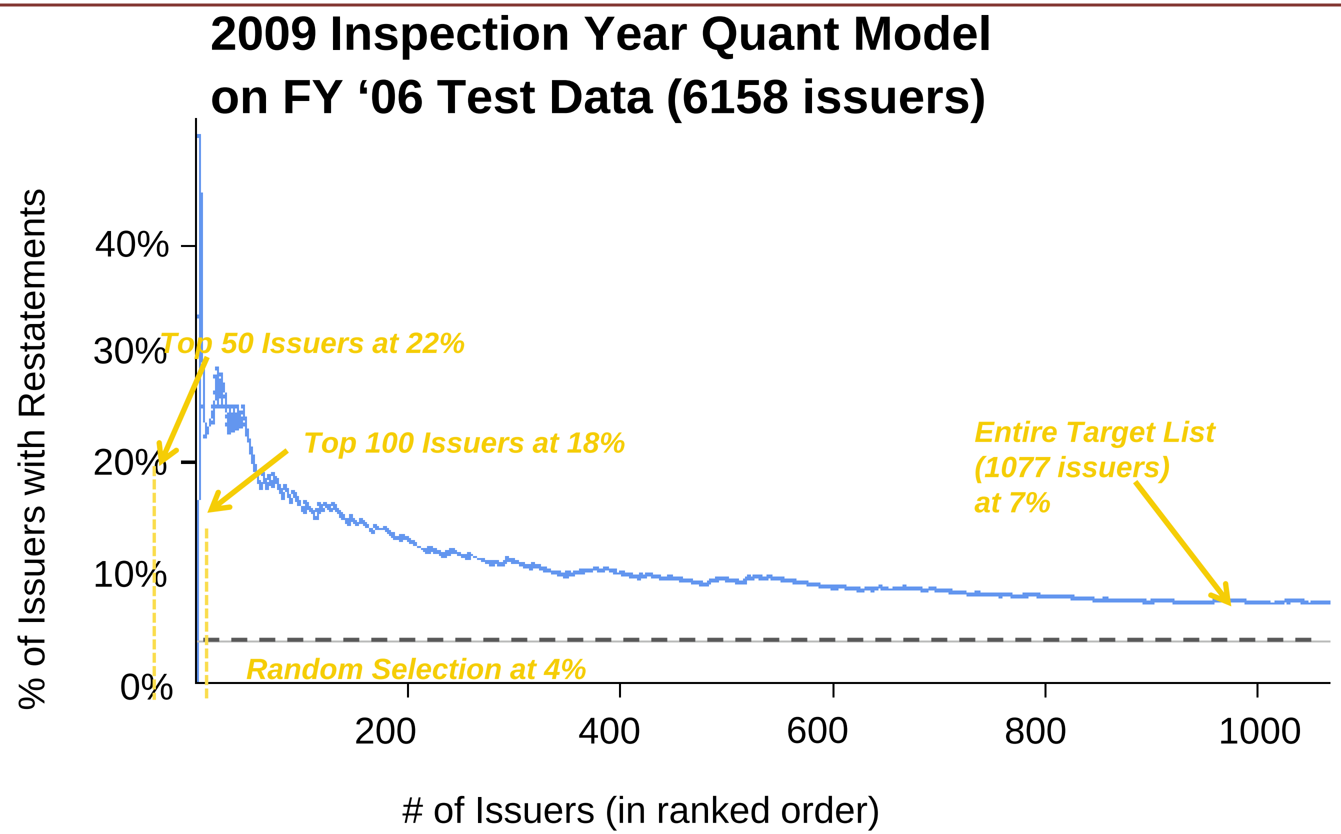
	2007	2008	2009	Totals
Issuer-Audits Inspected	437	347	371	1155
Issuer-Audits Inspected w/ Negative Events - Expanded Observation Period	105	58	42	205
Negative Event Rate for Issuer-Audits Inspected - Expanded Observation Period	24.0%	16.7%	11.3%	17.7%
Large 8 Negative Event Rate	8.3%	5.2%	4.5%	6.1%

Quant Model

Produce a list of higher risk issuer audits for consideration by PCAOB Inspections for their annual inspections using quantitative (data mining) techniques.

- The goal is to identify issuer audits with elevated risk of audit failure (companies with undetected misstatements)
- The quantitative model algorithm identifies patterns in attributes of issuers who restated in the past and looks for the same patterns in current issuers
- ORA also highlights aspects of financial statements
- The list is rank-ordered to reflect the relative probabilities of undetected financial statement misstatements

2009 Quant Model Back-testing



Hit rate (% of correctly flagged misstaters) declines with lower rank in the target list (backtested on 2006 data)

Peer-Reviewed Research

- We examine the impact of PCAOB inspections on client turnover at triennial firms during the First Cycle – paper is currently undergoing academic peer review
- In particular: Do firm with inspections findings:
  - Resign from more clients?
  - Be dismissed from more clients?
  - Gain more new clients?
- We have access to non-public inspections data and are also able to include the Part II findings in our analysis

Results

- Deficient PCAOB inspections' reports were significantly associated with the firms' decision to resign from issuer audits
  - Could be explained by reputational/compliance concerns
  - May have been trying to avoid comments in future inspections by resigning from "risky" audits
- PCAOB inspections' reports do not seem to be correlated with issuers' decisions to dismiss their auditors
  - However, a publicly available measure of audit quality, partner-to-staff ratio, was significantly correlated with dismissals
- Firms that received at least 1 public Part 1 comment were significantly more likely to receive new issuer-audits in the period following the release of their PCAOB inspections' reports

Findings

- We have some indication that there was a demand for firms that were perceived to provide lower quality audits
  - It could also be the case that there was a demand for lower cost audits and that there is a correlation between audit fees and audit quality
    - We will test this hypothesis in future versions of the paper

Emerging GAAP Issues

- Revenue recognition model – would replace over 200 pieces of accounting literature and fundamentally change the model
- Financial instruments and hedging – would represent a significant pullback in hedge accounting requirements, could impact dynamic hedging programs
- Fair Value – the sleeper; potential to affect risk transparency

Revenue from Contracts with Customers

Entities will perform the following five steps in applying the proposed standard:

- Identify the contract with the customer
- Identify the separate performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the separate performance obligations
- Recognize revenue when each performance obligation is satisfied

Revenue from Contracts with Customers

Current SAB 104 Criteria Required for Revenue Recognition	Proposed ASU ED:
• Persuasive evidence of an arrangement exists	• Contracts may be written, oral, or implied. An agreement must create enforceable rights and obligations
• Delivery has occurred or services have been rendered	• Recognition when control is transferred; rather than risks and rewards
• The seller's price to the buyer is fixed or determinable	• Recognize revenue if the transaction price can be reasonably estimated (including contingent amounts). No VSOE required.
• Collectibility is reasonably assured.	• Collectibility affects measurement of revenue, not recognition
• Bill & Hold Arrangements (i.e. SEC has specific criteria to be met in order to recognize revenue when delivery has not occurred)	• Does not require specific delivery date.

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w1 Double check statement.
wilfertg, 10/4/2010

Financial Instruments, Derivatives and Hedging

Core Deposit Liabilities will be measured at "Current" value which is the present value of average with the discount at the rate differential between the rate charged for the next best alternative source of funding and the all-in-cost to-service rate over the implied maturity.

Financial Instruments, Derivatives and Hedging

The proposed changes to hedge accounting Include the following:

- **Only qualitative assessments at inception required**; reassess only if circumstances suggest a change
- **Effectiveness threshold lowered from highly effective to reasonably effective for all FV and CF hedges; the proposal does not define reasonably effective**
- Elimination of shortcut method and the critical-terms-match method
- For cash flow hedges, ineffectiveness will be recognized for both overhedges and underhedges (and not just for underhedges)

Financial Instruments, Derivatives and Hedging

The proposed changes to hedge accounting include the following (continued):

- Dedesignation only if criteria for hedge accounting not met or hedging instrument expired, sold, terminated, or exercised (**Dedesignation will not be elective**.
- The proposal notes that an existing hedging relationship would not need to be terminated if an entity modifies the relationship by subsequently adding a derivative, provided the new derivative does not reduce the effectiveness of the hedging relationship and does not fully offset the existing derivative.
- However**, this may not be helpful for many dynamic portfolio hedging strategies** where entities adjust the hedged items and not the hedging instruments in the hedging relationship

Fair Value Measurements and Disclosures (Topic 820)

The Proposed ASU:

- Clarifies that principal market is the market with the greatest volume and level of activity for the asset or liability, not the entity's transaction volume
- Clarifies that transport costs are to be taken into account (in addition to transaction costs)
- Clarifies that the highest and best use and valuation premise concepts only apply to non-financial assets
- Clarifies that the objective is to determine the price for an individual asset (at the given unit of account)

Fair Value Measurements and Disclosures (Topic 820)

- Under current ASC 815 (SFAS 133) guidance, strict criteria are required to be met to achieve hedge accounting on a portfolio basis.
- The proposed ASU would allow entities to apply fair value measurements to only the entity's net exposure.
- The accounting impact to the income statement would be similar to short cut (or critical terms match for non-interest rate hedges) hedging treatment for assets and offsetting liabilities that are "substantially the same."

Fair Value Measurements and Disclosures (Topic 820)

Potential impact on auditors:

- "Substantially the same" is not defined in the Proposed ASU.
- Under ACS 815-20-25 (SFAS 133 para. 65 and 68), critical terms match or shortcut method, the terms must match exactly in order to assume there is no ineffectiveness in a hedging relationship. Ineffectiveness may occur if the assets and offsetting liabilities are not economically perfect hedges.
- Under the Proposed ASU any such ineffectiveness in the assets and offsetting liabilities would not be recorded in the income statement and/ or not disclosed, thus not transparent to investors.
- This proposed change could create unintended consequences, particularly in the area of basis risk.

Fair Value Measurements and Disclosures (Topic 820)

Basis risk arises in interest rate hedges where variable rates are based on different indexes or in the area of commodities. **Investors may lose transparency to basis risk.** Examples of basis risk include:

- Assets are indexed to three month LIBOR, however, the offsetting liabilities are indexed to six month LIBOR,
- Assets are indexed to LIBOR and the liabilities are indexed to something other than LIBOR,
- There is a timing difference between the settlement dates on the assets and the offsetting liabilities,
- The interest payment dates differ,
- The asset has a different prepayment characteristics than the offsetting liability,
- Commodity contracts hedged without regard to delivery locations or transportation costs, whether this is part of the entity’s trading strategy or not.

Fair Value Measurements and Disclosures (Topic 820)

- Auditors could be placed in a position in which they would need to have highly specific knowledge of market dynamics for the universe of potential hedging relationships in order to effectively identify basis risk in every instance.
- A clear definition of “substantially the same” and/or implementation guidance in the application of this criterion would be helpful to auditors.
- This guidance should clearly illustrate the application of “substantially the same” in cases where there could be basis risk or other potentially hidden risk.

Leases

Lessee Accounting:

- No more operating leases!
- Lessee will recognize “right-of-use” asset and a liability for obligation to pay lease rentals.
- Balance sheet will be grossed up with an obligation and an asset. The proposal effectively eliminates operating lease with off-balance sheet accounting by lessees .
- Lease will be recognized and carried at amortized cost, based on the present value of payments over the term of the lease
- Income statement geography and the recognition pattern for lease expenses will change. Straight-line rent expense would be replaced by amortization and interest expense. This would result in an acceleration of expense recognition, as interest on the obligation would be greater in the earlier years, similar to a mortgage.