SULLIVAN & CROMWELL LLP

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Audit Committees

SEC Approves New PCAOB Auditing Standard Relating to Communications Between Auditors and Audit Committees

The U.S. Securities and Exchange Commission has approved Auditing Standard No. 16, *Communications with Audit Committees*, in the form adopted by the Public Company Accounting Oversight Board in August 2012. As anticipated, the new standard will be effective for audits and quarterly reviews for fiscal years beginning on or after December 15, 2012. The SEC also approved the PCAOB's transitional amendment that makes the existing auditor communication requirements applicable to the audits of SEC-registered brokers and dealers if the SEC's proposal to subject broker-dealer audits to PCAOB standards is adopted and goes into effect before the new PCAOB standard is effective.

The approval of this standard required the SEC, for the first time, to engage in the determination called for by the Jumpstart Our Business Startups Act as to whether the application of a new PCAOB standard to "emerging growth companies" is necessary or appropriate in the public interest. Consistent with the position of the PCAOB, the SEC determined to apply the standard to emerging growth companies. The SEC's approval order contains a discussion of the SEC's analysis, including the SEC's responses to contrary arguments made in a comment letter submitted by the U.S. Chamber of Commerce.

We have attached our publication, dated September 11, 2012, describing the new auditing standard. While the new standard is directed at auditors, not issuers, SEC-reporting companies should evaluate the extent to which their audit committee agendas and, potentially, their audit committee charters should be updated to take into account the new required communications. We would be pleased to assist clients in this regard; please contact any of the lawyers listed at the end of the attached publication, or any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters.

September 11, 2012

Audit Committees

PCAOB Adopts New Auditing Standard Related to Communications Between Auditors and Audit Committees

SUMMARY

The Public Company Accounting Oversight Board has adopted Auditing Standard No. 16, *Communications with Audit Committees*, a new auditing standard addressing communications between auditors and audit committees that is intended to improve audits by enhancing the relevance and quality of these communications throughout the audit. The new standard will, if approved by the SEC, supersede the existing interim standards included in AU sec. 380 and AU sec. 310. Under the new standard, the auditors must communicate, among other things, the following to the audit committee in a timely manner and prior to the issuance of the auditor's report:

- an overview of the overall audit strategy, including the timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
- significant transactions that are outside the ordinary course of business or unusual and the auditor's understanding of the business rationale for such transactions;
- difficult or contentious matters for which the auditor has consulted outside the engagement team;
- complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention;
- a description of the process management used to develop critical accounting estimates, including the significant assumptions underlying highly subjective estimates;
- information about other accounting firms or accountants involved in the audit, and the basis upon which the auditors can serve as principal auditor if significant parts of the audit will be performed by affiliates or other auditors; and
- other matters arising out of the audit that are significant to the oversight of the company's financial reporting process.

In addition, when conducting a quarterly review of interim financial information, the auditor should determine whether any of the matters described in the new standard, as they relate to interim financial information, have been identified and, if so, should communicate them to the audit committee prior to the company filing its Form 10-Q with the SEC.

The new standard also seeks to encourage effective two-way communication between the auditor and audit committee and, in this regard, requires the auditor to inquire of the audit committee whether the audit committee is aware of matters that are relevant to the audit, including its knowledge of violations or possible violations of laws or regulations.

The PCAOB also adopted a transitional amendment to AU sec. 380 that makes the communication requirements in AU sec. 380 applicable to the audits of SEC-registered brokers and dealers in the event that the SEC's proposal to subject broker-dealer audits to PCAOB standards is adopted and goes into effect before the effective date of the new PCAOB standard.

Auditing Standard No. 16 and related amendments are subject to SEC approval. Subject to this approval, the PCAOB anticipates that the new standard will be effective for audits and quarterly reviews for fiscal years beginning on or after December 15, 2012. In addition, this is the first new PCAOB standard adopted since the enactment of the Jumpstart Our Business Startups Act and will apply to the audits of "emerging growth companies" (as defined under such act) only if the SEC determines that such application is necessary or appropriate in the public interest.

Although the new standard is directed at auditors, not issuers, SEC-reporting companies should evaluate the extent to which their audit committee agendas and, potentially, their audit committee charter should be updated to take into account the new required communications. Companies may determine to integrate this evaluation with an analysis of the guidance recently issued by the PCAOB as to the audit firm inspection process, which highlights several inspection-related areas that audit committees may wish to address in communications with auditors.[1]

BACKGROUND

On March 29, 2010, the PCAOB proposed for comment a new auditing standard, *Communications with Audit Committees*, to enhance the relevance and effectiveness of communications between the auditor and the audit committee throughout the audit. The PCAOB revised the standard in response to comments received during the public comment period and discussions held at a public roundtable in September 2010 and reproposed the standard for further public comment on December 20, 2011 (the "reproposed

[1] *See* Information for Audit Committees About the PCAOB Inspection Process, PCAOB Rel. No. 2012-03 (Aug. 1, 2012), *available at* http://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf. This guidance is discussed in our publication, dated August 9, 2012, entitled "PCAOB Issues Guidance to Audit Committees on Audit Firm Inspection Process."

standard”).[2] The reproposed standard took into consideration other standards adopted by the PCAOB as well as the PCAOB’s new oversight role as to the audits of brokers and dealers registered with the SEC, pursuant to Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The reproposed standard was further revised in response to comments received during another public comment period and was adopted by the PCAOB on August 15, 2012 (the “adopted standard”).[3]

The adopted standard reflects only a small number of changes from the December 2011 reproposed standard. These include changes to:

- revise the definition of “audit committee” to focus on the persons identified by the auditor as responsible for overseeing the accounting and financial reporting processes of the company;
- acknowledge that management might communicate certain matters related to significant unusual transactions to the audit committee and that the auditor would not be required to communicate such matters at the same level of detail as long as certain criteria are met; and
- revise communication requirements related to the auditor’s evaluation of the company’s ability to continue as a going concern to further align the communications with the auditor’s procedures related to such evaluation.

If approved by the SEC, the adopted standard would supersede the current interim standards governing communications between auditors and audit committees, AU sec. 380, *Communications with Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor* (together with AU sec. 380, the “current standards”). The adopted standard carries forward many of the existing communication requirements contained in the current standards, updated in several cases to reflect rules adopted by the SEC since 1999. 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 important to the identification and assessment of risks of material misstatement and fraud risks.

THE ADOPTED STANDARD

The adopted standard establishes certain requirements to enhance the relevance and quality of communications between auditors and audit committees. It requires the auditor to communicate certain matters related to the conduct of an audit to the company’s audit committee[4] and to obtain certain

2 For a discussion of the reproposed standard, please see our publication, dated March 1, 2012, entitled “PCAOB Reproposes Auditing Standard Related to Communications Between Auditors and Audit Committees.”

3 *See* Auditing Standard No. 16 – Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380, PCAOB Rel. No. 2012-004 (Aug. 15, 2012), *available at* http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf.

4 The adopted standard defines “audit committee” as a committee (or equivalent body) established by and among the board of directors of a company for the purposes of overseeing the accounting and

information from the audit committee relevant to the audit. These communications must occur in a timely manner and prior to the issuance of the auditor's report.[5] The PCAOB noted that existing requirements indicate "that audit committee communications are incidental to the audit and are not required to occur prior to the issuance of the auditor's report" whereas the new standard "recognizes the importance of the auditor's communication with the audit committee in today's business and regulatory environment." In addition, when conducting a quarterly review of interim financial information, the auditor should determine whether any of the matters described in the new standard, as they relate to interim financial information, have been identified and, if so, should communicate them to the audit committee prior to the company filing its Form 10-Q with the SEC.

The most significant changes from the current standards in terms of the content of communications include:

- ***Obtaining Information from the Audit Committee*** — The auditor should inquire of the audit committee whether it is aware of matters that are relevant to the audit, including, but not limited to, knowledge of violations or possible violations of law or regulations.[6]
- ***Communicating the Audit Strategy*** —The auditor should communicate to the audit committee:
  - An overview of the overall audit strategy, including a discussion of significant risks the auditor identified during its risk assessment procedures, the timing of the audit and any significant changes to the planned audit strategy or initially identified significant risks and the reasons for such changes;[7]
  - The extent to which the auditor plans to use the work of the company's internal audit function in an audit of financial statements;

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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 means the entire board of directors. For audits of non-issuers, if no such committee or board of directors (or equivalent body) exists, then the audit committee means the person or persons who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

5 The adopted standard provides an exception for registered investment companies. Consistent with Rule 2-07 of Regulation S-X, 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.

6 The PCAOB indicates that these communications should be "robust and substantive" and that the adopted standard does not preclude the auditor from requesting a confirmatory representation letter from the audit committee. The reproposed standard would have required the auditor to inquire of the audit committee "whether the audit committee is aware of matters that *might be* relevant to the audit." The adopted standard uses "are" in place of "might be" in order to avoid an overly broad interpretation. These inquiries expand on those 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 important to the identification and assessment of risks of material misstatement and fraud risks, including whether the audit committee is aware of tips or complaints regarding the company's financial reporting.

7 As part of communicating the audit strategy to the audit committee, the auditor should also discuss the nature and extent of specialized skills or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks. The PCAOB indicates that this disclosure should be made regardless of whether the specialist is from or outside the audit firm.

  - The extent to which the auditor plans to use the work of the company's internal auditors, other company personnel and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;
  - The names, location and planned responsibilities of other independent public accounting firms or persons not employed by the auditor that perform audit procedures;[8] and
  - The basis for the auditor's determination that it can serve as principal auditor, if significant parts of the audits will be performed by other auditors or affiliates of the auditor.
- ***Critical Accounting Estimates***[9] — The auditor should communicate:
  - A description of the process management used to develop critical accounting estimates;
  - Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and
  - Any significant changes made by management to these processes or assumptions, a description of the reasons for the changes and the effects of the changes on the financial statements.
- ***Significant Unusual Transactions*** — The auditor should communicate to the audit committee significant transactions, of which the auditor is aware, that are outside the normal course of the business for the company or otherwise appear to be unusual due to their timing, size or nature, and the auditor's understanding of the business rationale for such transactions.
- ***Difficult or Contentious Matters*** — The auditor should communicate to the audit committee any difficult or contentious matters for which the auditor consulted outside the engagement team and that the auditor reasonably determined were relevant to the audit committee's oversight of the financial reporting process.[10]
- ***Going Concern*** — The auditor should communicate to the audit committee the following matters relating to its evaluation of the company's ability to continue as a going concern:
  - If the auditor believes there is a substantial doubt about the company's ability to continue as a going concern for a reasonable time, the conditions and events the auditor identified that, when considered in the aggregate, indicate that there is such a substantial doubt;
  - If the auditor concludes, after consideration of management's plans, that such substantial doubt 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; and
  - If the auditor concludes, after consideration of management's plans, that such substantial doubt about a company's ability to continue as a going concern for a reasonable amount of time

[8] The adopted standard clarifies that this communication regarding other independent public accounting firms applies regardless of whether the other firms otherwise have any relationship with the auditor.

[9] "Critical accounting estimate" means 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 PCAOB states that this definition is intended to be the same as that used by the SEC for purposes of Management's Discussion and Analysis of Financial Condition and Results of Operations.

[10] According to the PCAOB, a difficult issue may not be synonymous with a contentious issue; a difficult issue may be an issue that requires consultation while a contentious issue might be an issue that requires not only consultation, but also leads to significant points of disagreement, debate or deliberation between the auditor and management.

remains, the effects, if any, on the financial statements, the adequacy of related disclosure and the auditor's report.[11]

- ***Uncorrected and Corrected Misstatements***— The auditor should communicate to the audit committee:
  - the schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management, and 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, and should communicate to the audit committee the fact that uncorrected misstatements or matters underlying them could potentially cause future-period financial statements to be materially misstated; and
  - 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 the implications that such corrected misstatements might have on the company's financial reporting process.
- ***Departure from the Standard Auditor's Report*** — If the auditor expects to modify the opinion in the auditor's report or include explanatory language in the auditor's report, the auditor should communicate to the audit committee the reasons for, and wording of, the modification or explanatory language.
- ***Other Matters*** — 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 process, including 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.

The PCAOB indicates that "communicate to" is intended to encourage effective two-way communication throughout the audit and that communications should be tailored to the circumstances and informative rather than "boilerplate" or standardized. These communication requirements are in addition to other PCAOB standards and rules, laws and regulations regarding audit communications. Although the adopted standard establishes certain communication requirements, it does not preclude auditors from providing, or audit committees from requesting, additional information.

TRANSITIONAL AMENDMENT TO AU SEC. 380 RELATING TO AUDITS OF CERTAIN BROKER-DEALERS

The PCAOB also adopted a transitional amendment to AU sec. 380 that makes the communication requirements in AU sec. 380 applicable to the audits of SEC-registered brokers and dealers prior to the effective date of the adopted standard.

Section 982 of the Dodd-Frank Act grants the PCAOB oversight of the audits of brokers and dealers registered with the SEC. On June 15, 2011, the SEC proposed amendments to Rule 17a-5 under the Exchange Act to, among other things, require that the audits of registered broker-dealers be performed in accordance with PCAOB standards, but the SEC has not yet adopted final rules.

[11] The final form of the adopted standard requires 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, rather than when there "could be" substantial doubt.

AU sec. 380 currently does not apply to 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. However, SAS 114, *The Auditor's Communication with Those Charged with Governance*, provides that AU sec. 380 applies to all brokers and dealers being audited under generally accepted auditing standards. If approved, the adopted standard would apply to the audits of all registered brokers and dealers without exception. The PCAOB anticipates that the transitional amendments to AU sec. 380 will be effective, subject to SEC approval, for periods that PCAOB standards become applicable to audits of brokers and dealers upon adoption of the proposed amendments to Rule 17a-5, if such periods precede the effective date of Auditing Standard No. 16.

EMERGING GROWTH COMPANIES

Section 104 of the Jumpstart Our Business Startups Act (the "JOBS Act") provides that any rules adopted by the PCAOB after April 5, 2012 do not apply to the audits of "emerging growth companies" unless the SEC determines such application to be "necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[12] Accordingly, the adopted standard will not apply to the audits of "emerging growth companies" unless the SEC determines that it is necessary or appropriate to apply the adopted standard to such audits. This is the first PCAOB standard for which the SEC will be required to make the determination called for by the JOBS Act. The PCAOB states in the release that it intends to request that the adopted standard be made available to emerging growth companies.

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[12] *See* Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002, as added by Section 104 of the JOBS Act. An "emerging growth company" generally means any issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year, other than a company that completed its initial public offering on or before December 8, 2011. For a discussion of the JOBS Act, see our publication, dated March 27, 2012, entitled "Congress Passes the 'Jumpstart Our Business Startups Act'."

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