



28 May 2010

Our ref: ICAEW Rep 50/10

Office of the Secretary
PCAOB
1666 K Street
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Washington
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By email:

comments@pcaobus.org

PCAOB Rulemaking Docket No. 030

Dear Sir

PCAOB RELEASE NO 2010 - 01: PROPOSED AUDITING STANDARD RELATED TO COMMUNICATIONS WITH AUDIT COMMITTEES AND RELATED AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS

The ICAEW welcomes the opportunity to comment on the proposed auditing standard on auditor communications with audit committees published by the PCAOB on 29 March 2010.

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Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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SIGNIFICANT ISSUES

1. The introduction to the PCAOB's proposals focuses on the provision of information by auditors to audit committees to enable audit committees to carry out their duty to protect investors. Current work in the UK has highlighted the significance of the work of audit committees with auditors and management in contributing to the value of audit. Audit committees perform a key role in upholding audit quality and investor protection, and it is important not to lose sight of these objectives. The audit committee, and the provision of information to it, are not ends in themselves and any guidance must necessarily be with a view to enhancing audit quality and investor protection. Audit committees make their best contributions when a balance is achieved between well defined compliance work, and an unstructured and informal element, unconstrained by the need for documentation of compliance with standards. Audit committee members need to be free to ask their own questions in order to function well. Our overall impression of these proposals is that they represent an attempt to mandate some of the unstructured element of audit committee operations in auditing standards, and to narrow the scope for the exercise of judgement by auditors, management and the audit committee alike. We are not convinced that this will improve audit quality or investor protection because auditing standards are not the best way to address deficiencies in how audit committees function. In this context we note an article in the May 2010 American Accounting Association Journal of Accountancy entitled *Audit Committee Member Investigation of Significant Accounting Decisions* which makes it clear that a key element of the effectiveness of audit committees depends on the quality and expertise of the audit committee members and not necessarily the provision of yet more information.
2. We are somewhat concerned that the PCAOB does not appear to have asked specific questions about a number of the additional requirements, such as the requirement to communicate about consultation outside the engagement team.
3. We note the fact that there might be more emphasis on communications from the audit committee to the auditor, but that it would not sit well in an auditing standard for auditors. This tension exemplifies point 1 above concerning the importance of some audit committee functions that are outside the boundaries of standards and compliance.
4. In isolation, few of the proposed changes appear unreasonable on the face of it but they all represent additional communications that are likely to require additional work. We are not convinced that they will enhance audit quality or the effectiveness of audit committees. The proposals appear to be written on the premises that audit committees are at present ill served by both auditors and management who are not communicating important information to them, and that it should fall to the auditor to remedy deficiencies in management communications with audit committees. We believe that the former premise is the exception and not the rule, and that the latter is contrary to the spirit of co-operation that is necessary in order for auditors to perform high quality audits. We urge the PCAOB to consider in all cases (a) whether auditors should be required to use their judgement in considering informing the audit committee about a particular matter, which is what happens at present, (b) what exactly the audit committee is likely to do with the additional information provided in the generality of cases, and (c) the possibility of unintended consequences should inappropriate communications be mandated, such as the relationship between management and auditors being undermined. There is also a risk that providing a detailed list communications requirements may result in boiler plate disclosures to satisfy the requirements of an auditing standard which make it harder for audit committees to discern the more significant matters.
5. The PCAOB might wish to consider whether any issue of under-communication by auditors might be better addressed through the inspection process.

6. We appreciate that the proposed standard is necessarily predicated on a US corporate governance model in which the audit committee exercises oversight over management and appoints the auditor, and in which, implicitly, helping the audit committee fulfil its functions takes precedence over the relationship between auditor and management. In jurisdictions such as the UK, the audit committee is a sub-committee of the board, and recommends the auditor to the shareholders, who appoint auditors. Many other variations exist. Nevertheless, the audit is normally for the benefit of the stockholders and/or the capital markets and not for the audit committee or the board. It would be helpful if the proposals recognised that auditors of foreign private issuers may need to consider how the requirements of the standard should be applied in the context of the corporate governance requirements of the relevant jurisdiction. We draw attention in this context to the UK's Audit Quality Forum publication, *The Impact of Audit Committees on Auditing* which analyses the differences between the impact of audit committees on auditing in the UK and the US and can be found at www.icaew.com/auditqualityforum.
7. In our 2 March 2010 response to the PCAOB on its exposure of the risk standards, we encouraged the PCAOB to effectively challenge the IAASB in areas in which it believes that ISAs should be improved. We noted that in order for that challenge to be effective, there is a need for the PCAOB to be robust and detailed in its explanations of differences between PCAOB standards and ISAs¹. We encourage the PCAOB once again to improve the quality of these explanations and we give specific examples below. This type of challenge is an important part of the convergence process, which is not well-served by the small wording differences or relatively inconsequential additional requirements noted in our detailed responses and 'other matters' below.
8. In our response to the PCAOB on the risk standards, we also noted a need for a description of the significant differences that the PCAOB believes exists between the proposed standards and ISAs and ASB standards, and vice versa, and this remains true in this exposure draft. The PCAOB should also be clear about the significant changes it expects to audit practice as a result of its proposals.
9. *Communicating consultation outside the engagement team*: we are concerned that an unintended consequence of this proposal might be to discourage necessary consultation. Issues consulted on are likely to be significant anyway and would therefore be communicated to the audit committee as such. The requirement might undermine the necessary authority of the engagement partner. In practice, auditors may well communicate such matters to the audit committee but this, like several other requirements, should be considered as a matter of judgement because communication is not always appropriate. There is also an issue with defining what counts as a consultation given different practices within firms both small and large. Does a telephone call, a chat in the corridor or a brief email exchange mentioning the issue in passing represent an enquiry or a consultation? We also wonder whether such matters might be construed as including matters discussed with the SEC Practice Section Review undertaking the Appendix K review, which we do not believe should be the case. The proposals state that these consultations do not include discussions with the engagement quality reviewer and it would help if this could be explicitly expanded to cover the SEC Practice Section Reviewer.
10. *Communication of misstatements*: In practice, significant misstatements are reported regardless of whether management or auditors discover them or whether they are corrected; audit committees find this valuable because it reflects on the quality of financial reporting processes. However, the paragraph 17 requirement to report a detailed schedule of uncorrected misstatements seems unrealistic because in practice, summaries are reported and we would not

¹ '.....going forward, it will be enormously helpful to the international standard-setting process if the PCAOB can be crystal clear about which areas of PCAOB standards it believes to be technically better than ISAs, and why. The PCAOB should challenge the IAASB in areas in which it believes ISAs can and should be improved.'

expect audit committees to find additional value in being provided with the same level of detail as management.

11. *Accounting policies and critical accounting estimates*: the paragraph 12 note *can* be read as suggesting that auditors, instead of focusing on their own views on such matters and communicating them, should assess whether management has adequately described such matters to the audit committee, and to step in if not. This is problematic. There would appear to be much greater value in an auditor assessment of such issues independently of management than in auditors attempting to prove a negative by determining what has not been communicated, and filling in the gaps. If this is not the intended meaning of the note, it might be made clearer. There is value in some duplication of reporting by management and auditors in such areas in any case. In practice, matters that have been missed by management *are* communicated by auditors but to permit auditors to rely on what management has communicated as being adequate might result in poorer quality communications overall. The detailed requirements of this paragraph imply that auditors should communicate very detailed matters that are the responsibility of management. It might be helpful to note that such disclosures are expected to be rare, and that the requirement is intended to act as a spur to management to make the required disclosures. Auditors might be encouraged instead to comment to the audit committee on the information management *is* proposing to disclose under SEC requirements and/or GAAP².
12. *Communication of consultations between management and lawyers etc*: the rationale for this proposal is not clear. The question arises (again) as to what exactly constitutes a consultation and in any case, such issues are (again) likely to be significant and reported on that basis.
13. It would be helpful for each PCAOB pronouncement to explain clearly the status of the requirements, the notes and the appendices, particularly when they cover a variety of types of material as in this case.

ANSWERS TO SPECIFIC QUESTIONS

1. *Are the objectives of the auditor in the proposed standard appropriate? If not, why? Should other matters be included in the objectives?*

2. *Are the objectives adequately articulated? Should the articulation of the objectives focus on the outcome that should be achieved by performing the required procedures?*

The objectives suffer from the same flaws as the objectives in the ISA, in that they amount to little more than a summary of the requirements. This is partly a result of a lack of foundational principles for the development of objectives, a weakness in both PCAOB and IAASB standard-setting. A starting point for the development of the extant ISA was, of course, the extant US standards. We are concerned that these flaws are becoming embedded and self-perpetuating and we encourage the PCAOB to take the opportunity to break this cycle. Part of the purpose of an objective is to enable an auditor to stand back and ask whether there are any necessary additional audit procedures, beyond those required by the standard, to achieve the objective. This is not possible if the objectives only summarise the requirements. We agree that objectives should articulate the outcome; they do not do so at present. We note in particular item (d) which requires the auditor to evaluate the adequacy of the two-way communication process, and we disagree with the PCAOB's rationale for including it. A requirement to evaluate is not an objective, but a requirement, and it effectively requires the auditor to evaluate his own performance as part of the communication process; the PCAOB notes the corresponding ISA requirement which is to 'promote' the two-way communication process and dismisses it on the basis

² Paragraph 125 of IAS 1 (revised 2007), *Presentation of Financial Statements*, includes, *inter alia*, a requirement to disclose '*...information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year...*'.

that there are 'no related requirements'. We do not agree that there are no related requirements – the related requirements are the requirements in the ISA to evaluate the process. The outcome, purpose and objective of evaluation are promotion of the process. To align requirements and objectives such that they are indistinguishable renders the distinction inoperative, and is to misunderstand the nature of both objectives and requirements. 'Promotion' is an intentionally wider and higher target than merely evaluating a process. We also note that question 18 below refers to the promotion of two-way communication.

We struggle to understand either the substance or the significance of the slight wording differences with the ISA wording in item (b) – the ISA requires auditors to communicate the planned scope and timing of the audit, the PCAOB proposes communication of the audit strategy and timing.

3. Is it appropriate for the proposed standard to require that an engagement letter be prepared annually? If not, why?

Yes. The difference with the ISAs in this case can be justified by the different population to which PCAOB standards apply. ISAs apply much wider variety of audit engagements.

4. Are there other matters that would enhance investor protection that should be added to an engagement letter? If so, what other matters should be included in an engagement letter?

Not that we are aware of.

5. Is the proposed requirement to inquire of the audit committee appropriate? What other specific inquiries, if any, should the proposed standard include for the auditor to make of the audit committee?

Assuming the inquiry referred to is in paragraph 8 of the proposed standard regarding complaints and concerns (the question is not clear), the proposed requirement is not objectionable (even though there is no corresponding requirement in the ISA), but we question whether an auditing standard is the right place to effectively impose a requirement on the audit committee to communicate such matters to the auditor. We are also concerned that the auditor might be overwhelmed by communications of frivolous or vexatious complaints and, assuming that only significant complaints and concerns are to be communicated, such matters would be communicated in any case under other requirements of the standard. Or is the auditor being asked to second guess judgements made about complaints to the audit committee?

6. Are the requirements to provide information on the auditor's audit strategy and timing of the audit appropriate? Does the auditor need more guidance related to the requirement to provide information on the auditor's audit strategy? If so, what type of guidance would be helpful?

Yes, and No.

7. Is it sufficiently clear which types of arrangements should be communicated to the audit committee related to the roles, responsibilities, and locations of firms participating in the audit?

Material on page 9 of the preamble in appendix 3 about affiliated and network firms and related arrangements is relevant and might be included in paragraph 10 (d) of the proposed standard.

8. Are the proposed requirements regarding the auditor's communication responsibilities with respect to accounting policies and practices sufficiently clear in the proposed standard (e.g., is the difference between a critical accounting policy and a significant accounting policy or practice adequately described)?

The new requirement for auditors to communicate matters on which they have consulted outside the audit team is discussed above under 'significant issues'. We do not believe that a good case has been

made for this new requirement. There may well be practical problems in applying it and indeed the proposal may in fact be counter-productive in that it might discourage necessary consultation. Assuming that an operational definition of what constitutes a consultation can be found then issues consulted on are likely to be significant. Auditors may well communicate such matters to the audit committee under other requirements of the standard and this, like several other requirements, should be a matter of judgement to be considered by the auditor because communication is not always appropriate.

Paragraphs 12 and 13 appear complex in comparison with ISA 260 paragraph 16 (a) and appendix 2 but they are generally clear, and part of the complexity comes about through the incorporation of Regulation S-X requirements around critical accounting policies and practices, which is valuable. It would help, however, to clarify that the 'significant accounting policies and practices' in paragraph 13 (a) are the same as those referred to in paragraph 12 (a).

The new requirement to communicate, if management has not, the anticipated application of new accounting requirements that are not yet effective would require the auditor to effectively do management's job for them, which for some complex standards could involve a significant amount of work and might breach the auditor independence requirements.

9. Is it helpful to include in the proposed standard the audit committee communications required by the SEC relating to accounting matters?

Yes.

10. Is the definition of critical accounting estimates appropriate for determining which estimates should be communicated to the audit committee?

Yes.

11. Are the communication requirements regarding critical accounting estimates appropriate? If not, how should the proposed standard be modified to provide appropriate information to the audit committee?

These matters are discussed above under 'significant issues'. The paragraph 12 note possibly permitting auditors to fill in gaps on what management has reported, instead of forming their own view on such matters and communicating them, might result in poorer quality communications overall.

12. Should this requirement be expanded to include consultations on accounting or auditing matters with non-accountants, such as consulting firms or law firms?

This requirement should be extended, as the distinction between the roles of accounting and law firms is not always clear or significant in the US environment.

13. Is the communication requirement on going concern clear? If not, how could the requirement be clarified?

Yes, although we do not agree that the IAASB has similar requirements to the PCAOB's proposed requirements and we continue to urge the PCAOB to move further towards the international position in this area.

14. Are the requirements appropriate regarding the communications for uncorrected misstatements?

15. Should all corrected misstatements including those detected by management be communicated to the audit committee?

These matters are discussed above under 'significant issues'. The PCAOB should have the same requirements for corrected and uncorrected misstatements given that in practice, significant misstatements are reported regardless of who found them or whether they are corrected.

16. Like the existing standard, the proposed standard would allow the auditor to communicate many matters orally or in writing. Should the standard require that all or certain matters be communicated to the audit committee in writing? If only certain matters should be communicated to the audit committee in writing, what are those matters?

The ISA requires that matters must be in writing where oral communications are inadequate which does not seem to be an onerous requirement. In practice, anything of any significance should be documented in any case.

17. Are the requirements in the proposed standard on the timing of the auditor's communications appropriate? Should only certain matters be communicated annually? If so, which ones?

The requirements are appropriate in this context.

18. Does the requirement to evaluate the adequacy of the communication process promote effective two-way communications? Is more information on this requirement needed?

Yes, and No, although we note under 'significant issues' above our preference for the promotion of effective two-way communications as an objective (over evaluation).

19. Are these other communication requirements appropriate and sufficiently clear? What other communication requirements should the proposed standard include, if any?

We are not convinced by the rationale for holding over the paragraph 4 requirement which is likely to be covered by other requirements in any case. Significant issues discussed with management prior to appointment or retention reflect conditions existing before the audit committee hired the auditors and it may not be appropriate to retain it from AU 380.

20. Are the matters included as significant difficulties in paragraph 21 of the proposed standard appropriate? What other matters should be included as significant difficulties?

Wording differences with the ISA should be eliminated as all of them are insignificant ('Restrictions imposed on the auditor by management.' vs. 'Unreasonable restrictions imposed on the auditor by management,' for example).

21. Are any of the requirements included in the proposed standard inappropriate for auditors to communicate to audit committees based on the size or industry of the company under audit?

No.

22. Is the information included in Appendices A - C to the proposed standard sufficiently clear? Should the appendices include other matters, e.g., should other items be included in an audit engagement letter.

This matter is discussed above under 'significant issues'. It is important that the status of the appendices is clear.

OTHER MATTERS

Whilst not part of the standard, the comparison of ISAs, SAS and the PCAOB's proposals is incomplete, in a number of areas. For example, the proposed standard requires the auditor to inquire of

the audit committee about whether they are aware of other matters that may be related to the audit, including complaints or concerns raised regarding accounting or auditing matters. The proposal states that the proposed auditing standard *Identifying and Assessing Risks of Material Misstatement* includes a requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks. The proposal goes on to state that ISA 260 and SAS 114 do not contain a similar requirement. This is true but there is a requirement in ISAs 315 and 240 for auditors to make inquiries of those charged with governance as part of their understanding of the nature of the entity and the system of internal control. There are also specific requirements in ISA 240 to make inquiries of those charged with governance regarding actual, suspected or alleged fraud and to consider whether the information gathered as part of understanding the entity and its environment is indicative of a risk of material misstatement due to fraud.