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**Inspection Observations Related to PCAOB Rules and Auditing Standards on  
Communications with Audit Committees**

**PCAOB Release No. 2016-001  
April 5, 2016**

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INSPECTION OBSERVATIONS RELATED )  
TO PCAOB RULES AND AUDITING )  
STANDARDS ON COMMUNICATIONS WITH )  
AUDIT COMMITTEES )

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**I. Background**

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing this report to provide information regarding audit firms' and audit engagement teams' implementation of, and compliance with, AS 1301, *Communications with Audit Committees* (currently AS No. 16)<sup>1</sup> and other PCAOB rules and standards related to audit committee communications. This report is based on the PCAOB's 2014 and preliminary 2015 inspection results relating to domestic and non-U.S. registered firms ("firms" or "registered firms"). AS 1301 became effective for audits of fiscal years beginning on or after December 15, 2012. The standard requires the auditor to communicate with the company's audit committee regarding certain matters related to the conduct of an audit and to obtain certain information from the audit committee relevant to the audit. Appendix B in AS 1301 also includes references to specific audit committee communication requirements under other PCAOB rules and standards, most of which were in effect prior to the adoption of AS 1301.

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<sup>1</sup> On March 31, 2015, the PCAOB adopted amendments that reorganize and renumber its auditing standards, effective December 31, 2016. (See PCAOB Release No. 2015-002.) The new numbering may also be used in advance of that date, and this Board report uses the prospective numbering. The first time a standard is cited, this document also parenthetically indicates the current number.

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**Effective Communication with Audit Committees under AS 1301**

The audit committee plays an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to a company's shareholders and others to oversee the integrity of a company's accounting and financial reporting processes and audits. The audit committee, among other things, serves as the principal interface between the company's board of directors and its auditors. It facilitates communications among the company's board of directors, its management, and its independent auditors on significant accounting issues and policies.

AS 1301 was adopted to improve the audit by establishing requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. The enhanced communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, and thereby benefit investors. Effective two-way communication between the auditor and the audit committee throughout the audit will assist in understanding matters relevant to the audit and is beneficial to achieving the objectives of the audit.

**2014 Inspections**

In 2014, PCAOB Inspections staff ("Inspections staff") conducted inspections of 219 firms and reviewed portions of 789 issuer audits for those firms. Of the 789 issuer audits inspected, AS 1301 was applicable in 551 (or 70 percent) of those audits based on the effective date of the standard. Of these 551 audits, 335 were performed by 41 member firms of the six largest global networks<sup>2</sup> and 216 were performed by 97 other firms.

In addition to the inspection procedures performed on these 551 audits to evaluate compliance with the requirements of AS 1301 on each engagement, Inspections staff also performed specific procedures to evaluate 125 firms' actions to implement the standard in their audits. The specific procedures performed by Inspections staff to evaluate the firms' implementation efforts varied according to the size of the firm, and included inquiring about or reviewing the following firm actions or materials with respect to AS 1301:

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<sup>2</sup> The six largest global networks (in terms of the number of PCAOB-registered non-U.S. member firms) are BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative, and PricewaterhouseCoopers International Limited.

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- Changes that were made to firms' audit methodologies;
- Materials that were provided to firms' staff during training;
- Implementation guidance prepared by firms;
- Firms' implementation tools, such as practice aids; and
- Firm monitoring procedures and other similar actions taken to evaluate engagement teams' compliance with the requirements of AS 1301 on individual audits.

Inspections staff also conducted interviews with both the audit committee chairs and engagement partners on approximately 140 audits selected for inspection to obtain a more in-depth understanding of the relevance, timeliness, and quality of the communications between the auditor and the audit committee. These interviews included discussions related to the following topics:

- The relationship between the auditor and the audit committee;
- Whether there were any significant changes in the interaction between the auditor and the audit committee in 2013 compared to prior years;
- The effect, if any, the audit committee had on the scope of the audit; and
- The audit committee's reaction to the significant risks communicated by the auditor.

## II. Overall Findings

### *Observations on Implementation of AS 1301*

Inspections staff found that most firms had incorporated the requirements of AS 1301 into their audit methodologies, introduced relevant practice aids, or provided training to their partners and staff. Implementing appropriate methodologies, however, did not always translate into auditors communicating to the audit committee all of the information required under the standard.

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*Observed Deficiencies on Audit Engagements*

In 36 audits (or seven percent) of the 551 audits inspected in 2014, Inspections staff reported deficiencies in complying with the requirements of AS 1301. While AS 1301 requires the auditor to communicate to the audit committee the results of related audit performance requirements in other PCAOB standards, or the conduct of the audit, it does not impose new performance requirements. As a result, the AS 1301 deficiencies did not by themselves result in an insufficiently supported audit opinion, but nevertheless constituted departures from the requirements of that standard and indicated a potential defect in firms' systems of quality control.<sup>3</sup>

These failures to comply with AS 1301 were more often identified in audits conducted by firms other than member firms of the six largest global networks and included instances in which firms did not:

- Communicate an overview of the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified;<sup>4</sup>
- Communicate, where applicable, that the firm believed there was substantial doubt about the issuer's ability to continue as a going concern<sup>5</sup> and that it expected to include an explanatory paragraph to that effect in its audit report;<sup>6</sup> and
- Sufficiently document oral communications made to the audit committee regarding certain matters related to the conduct of the audit.<sup>7</sup>

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<sup>3</sup> As required by the Sarbanes-Oxley Act of 2002, inspection report criticisms of a firm's system of quality control are included in the nonpublic portion of the relevant inspection report and remain nonpublic unless the firm fails to address the criticism to the satisfaction of the Board within 12 months following the issuance of the report.

<sup>4</sup> See paragraphs 9 to 11 of AS 1301.

<sup>5</sup> Paragraph 17 of AS 1301 indicates that the auditor has a responsibility to provide this communication for every report issued that meets this criterion.

<sup>6</sup> See paragraph 21 of AS 1301.

<sup>7</sup> See paragraph 25 of AS 1301.

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Inspections staff identified some instances where firms had incorporated the requirements of AS 1301 in their audit methodologies, but engagement teams did not use the revised methodologies or practice aids when planning or documenting their audit committee communications.

### *Interviews with Audit Committee Chairs*

Audit committee chairs generally indicated to Inspections staff that effective two-way communication with their auditors had occurred. Some audit committee chairs indicated there had been improvements after the effective date of AS 1301 related to the robustness and formality of communications with their auditors, including more in-depth discussions with the auditor about audit progress, significant risk areas, and audit findings. Other audit committee chairs stated that their auditors had been communicating the matters required to be communicated under AS 1301 even before the standard came into effect and, accordingly, these audit committee chairs had not observed a significant change in their communications with their auditors in 2013.

Most audit committee chairs stated that the significant risks, including fraud risks, communicated by the auditor and the planned scope of the audit were appropriate. Audit committee chairs also noted that they focused their discussion on certain audit risks most applicable to the issuer, including revenue due to the presumed fraud risk, income taxes, emerging markets in foreign locations, and mergers and acquisitions.

### **III. Preliminary Observations from 2015 Inspections**

In regards to the 2015 inspection cycle, the Board has issued inspection reports for certain firms and Inspections staff is in the evaluation and drafting stages for the remaining inspection reports. Preliminary inspection results indicate the number of inspection deficiencies related to audit committee communications required by AS 1301 has remained consistent with the 2014 inspection cycle. However, these inspection deficiencies were more frequently identified in triennially inspected firms that were inspected for the first time under this standard.

In 2015, the deficiencies identified by Inspections staff related to audit committee communications are similar to those identified during the 2014 inspection cycle. For example, several deficiencies identified in 2015 relate to the firms' failure to communicate an overview of the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified.

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**IV. Communications with Audit Committees Required by Other PCAOB Rules and Standards**

In addition to the audit committee communication requirements included in AS 1301, other PCAOB standards and rules require the auditor to communicate specific matters to the audit committee and are referenced in Appendix B to AS 1301. Inspections staff identified deficiencies during the 2015 and 2014 inspection cycles related to these standards and rules that were most frequently observed in triennially inspected firms and include instances in which auditors:

- Did not make the required communications to the audit committee concerning independence;<sup>8</sup>
- In required communications with audit committees regarding independence, inaccurately described PCAOB rules as requiring that the firm describe to the audit committee those relationships that, in the auditor's professional judgment, bear on independence, when in fact, the relevant rule is not qualified by reference to an auditor's professional judgment;<sup>9</sup>
- Did not inquire of the audit committee about the risks of material misstatement, including fraud risks;<sup>10</sup> and

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<sup>8</sup> Certain communications concerning independence are required by PCAOB Rule 3526.

<sup>9</sup> PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, requires the auditor annually to provide the audit committee with a written description of relationships that “may reasonably be thought to bear on independence.” While auditors must exercise sound judgment in carrying out their responsibilities, the determination necessary under Rule 3526 requires the auditor to consider how a reasonable third party, not the auditor, would view the relationship. (See PCAOB Release No. 2008-003, Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence* (April 22, 2008).)

<sup>10</sup> Such communications are required by AS No. 12, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 5.f. and 54-57.

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- Insufficiently communicated to the audit committee the scope of tax services performed and the potential effects of all tax services on the independence of the firm.<sup>11</sup>

The deficiencies in communications with audit committees discussed above were not pervasive across firms and were also observed in years prior to the implementation of AS 1301, as these other PCAOB standards and rules had been adopted prior to AS 1301.

**V. Actions Needed to Effectively Implement and Comply with PCAOB Rules and Auditing Standards on Communications with Audit Committees**

The Board is encouraged by the fact that most firms had incorporated the requirements of AS 1301 into their practices and that in 93 percent of the audits inspected during 2014 where AS 1301 was applicable, Inspections staff identified no failures to comply with the requirements of the standard.

Firms that have not conducted a thorough review of the requirements in AS 1301 for purposes of incorporating them into their practices should do so to provide reasonable assurance regarding compliance with AS 1301 and the other applicable PCAOB rules and standards discussed above. Methodologies and practice aids that do not comply with these standards may lead to ineffective communications between auditors and audit committees, which may increase the risk of auditors not obtaining an understanding of all of the matters relevant to the audit, including the risks of material misstatement.

Firms should also assess whether the training provided to audit staff provides reasonable assurance that their auditors have a sufficient understanding of AS 1301 and the other applicable PCAOB rules and standards discussed above. A lack of knowledge of the extent of information required to be communicated to the company's audit committee regarding certain matters related to the conduct of the audit may increase the risk that the auditor may not communicate all of these matters or may not meet all applicable independence rules and standards.

All registered firms should review this report and consider whether the auditing deficiencies that the Inspections staff have observed could manifest themselves in their practices. If deficiencies in communications with audit committees have been identified,

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<sup>11</sup> Such communications are required by PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.



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firms should perform root cause analyses and take appropriate corrective action. Firms also need to monitor and evaluate whether their corrective actions adequately address the deficiencies.