

# **CAQ Practice Aid**

## **Discussions with Audit Committees About Inspection Findings and Quality Control Matters**

*(Note: This practice aid should not in any way be construed as legal advice.)*

### **Background**

The Center for Audit Quality (CAQ) believes that transparent, candid communication between an audit committee and its independent audit firm about the firm's internal quality control system, including information about the nature and impact of internal and PCAOB inspection results, supports the audit committee's role in overseeing the external auditor. Thus, the CAQ supports appropriate interactions and communications between auditors and audit committees consistent with the objectives of the Public Company Accounting Oversight Board's August 1, 2012, Release No. 2012-003, *Information for Audit Committees about the PCAOB Inspection Process* (the "Release"). The Release specifically identifies topics audit committees may wish to discuss with auditors in order to gain a better understanding of PCAOB inspections of audit firms.

Many audit firms engage in discussions with audit committees about inspections and quality control matters. As part of its commitment to share best practices across its member firms, the CAQ has developed a practice aid that encourages all firms to proactively communicate in a timely, forthright and robust manner<sup>1</sup> information about relevant quality control matters – including those related to inputs from internal firm reviews, peer reviews and PCAOB inspections – and improvements they are making to their systems of quality control.

Communications with an audit committee regarding audit deficiencies identified by a PCAOB or internal inspection of the issuer's audit engagement should explain the nature of the finding, including the audit procedures considered to be either omitted or insufficient, the audit firm's perspective on the issues identified, and the nature and extent of any additional audit procedures that were performed to address the deficiency. Also, where applicable, audit committees might also consider inquiring about the results of other publicly available foreign regulatory reviews that impact the audit of the issuer. Importantly, the audit committee should also be informed if the issuer's underlying accounting or management's assessment of internal control over financial reporting has been called into question.

The timing for discussing various aspects of inspections activity with audit committees should be considered. For example, the auditor should promptly notify the audit committee if that issuer's audit engagement is selected for PCAOB inspection, rather than wait for the subsequent issuance of the inspection report. The audit committee should remain appropriately informed of the progress of that inspection up to and through issuance of the final report.

In addition to information on inspections of an issuer's audit engagement, an audit committee would benefit from receiving information about the firm's overall system of quality control and improvements being made to it. The CAQ recognizes, as did the Release, that firms for many reasons may decide not to provide a copy

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<sup>1</sup> The frequency of certain aspects of these communications may differ for firms that are on a three-year inspections cycle.

of Part II of their PCAOB inspection report<sup>2</sup>, most significantly the potential waiver of the privilege created by the Sarbanes-Oxley Act<sup>3</sup> with respect to that information<sup>4</sup>. Regardless, the CAQ believes an audit committee can obtain useful information about a firm's commitment to quality through a discussion with the auditor about the changes the firm is making to address any issues identified in its system of quality control.

The form of these communications should be decided by each firm. Communications should accomplish the objective of candidly conveying the steps the firm is taking to improve its system of quality control based on all of its quality inputs (both internal and external sources of such information). Importantly, the process of summarizing issues raised from several different sources should in no way minimize or downplay the significance of the matters identified through each of the firm's quality control inputs, including the PCAOB's Part II observations.

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### **Communicating Inspection and Quality Control Matters to the Audit Committee**

To inform auditor and audit committee communications regarding internal and PCAOB inspections and quality control improvement, consideration should be given to the PCAOB's August 1, 2012 Release. Communications with an audit committee should be tailored to the needs of each audit committee. A firm should contemplate the following elements in developing its tailored communications plan:

- A. *Whether the issuer's audit was selected for inspection by the PCAOB and, if so, the status of the progress of that inspection as deemed necessary.* A firm should notify the audit committee that the company's audit has been selected and the areas of focus of the inspection, and provide updates as appropriate. An important context for how the audit committee might view this information, as well as for how it might carry out its fiduciary responsibilities with respect to the issuer, is the audit committee's understanding of the PCAOB's risk-based approach for selecting engagements and areas of inspection focus – something the auditor should communicate to the audit committee. A firm should also communicate any findings identified by the PCAOB concerning the audit or the issuer's financial reporting. For example, a firm should inform the audit committee:
  - i. if the PCAOB informs the audit firm that an audit opinion on the issuer's financial statements or internal control over financial reporting may not be sufficiently supported;
  - ii. if the PCAOB informs the audit firm that the financial statements may contain a material misstatement or an inadequate disclosure;
  - iii. if the PCAOB informs the audit firm of a concern with the adequacy and/or effectiveness of the issuer's internal control over financial reporting; or
  - iv. if the PCAOB informs the audit firm that the audit firm's independence may have been impaired relative to the issuer.

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<sup>2</sup> Part II is the non-public portion of the PCAOB inspection report. Sarbanes-Oxley Act Section 104(g) restricts the Board from making this section public unless the firm does not address the issues to the PCAOB's satisfaction within 12 months after the date of the inspection report.

<sup>3</sup> See Sarbanes-Oxley Act of 2002, Section 105(b)(5)(A).

<sup>4</sup> Prior to any discussion with the audit committee regarding issues related to Part II of the inspection report, the firm may wish to consult with legal counsel.

Audit committees should also be informed of audit deficiencies related to any of the matters in i – iv that are identified during a firm’s internal inspections.

- B. *Information about the firm’s responses to the PCAOB findings with respect to the issuer’s audit.* A firm should clearly communicate to the audit committee any PCAOB findings. In addition, if the auditor concludes, based on those findings, that certain additional audit procedures were necessary, the firm should communicate that information to the audit committee. If the firm concluded that no additional work was required, that fact and the reasons supporting that conclusion also should be communicated.
- C. *Whether any of the matters described in the public portion of a PCAOB inspection report on the firm, including matters not involving the issuer’s audit, involve issues and audit approaches similar to those that arose in the audit of the issuer’s financial statements.* To the extent any common area of findings exists in the internal or PCAOB inspections results that would be relevant to the issuer, the auditor should explain how such issues were addressed in the planning or execution of the audit of the issuer’s financial statements. For example, the firm might describe its implementation of policies or procedures to address the findings in the public portion of the PCAOB inspection report.
- D. *What steps the firm is taking to address issues identified with respect to its system of quality control.* A firm should provide information about enhancements to its system of quality control based on all of its quality inputs, including internal inspections, peer reviews, and Part I and II of the PCAOB inspection report. Inspections of quality control systems typically review certain of a firm’s practices, policies and procedures concerning audit performance, including in the following areas: (1) management structure and processes, including the tone at the top; (2) partner management; (3) engagement acceptance and continuance; (4) use of audit work performed by foreign affiliates; and (5) monitoring audit performance (including monitoring for deficiencies in audit performance, independence policies and procedures, and for responding to weaknesses in quality control).
- E. *Whether issues described by the PCAOB in general reports summarizing inspection results across groups of firms (also known as ‘4010 Reports’) relate to the audit of the issuer’s financial statements and internal controls over financial reporting, and how the firm is addressing those issues.* For example, to the extent such matters relate to the issuer’s audit, the firm might describe its implementation of policies or procedures to address such matters.