CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

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CAQ Public Policy Monitor

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As part of the Center for Audit Quality's ongoing effort to keep members informed on critical public policy matters with the potential to impact the public company audit profession, we are pleased to offer the Public Policy Monitor. Each month, the CAQ Public Policy Monitor highlights and examines the policies and broader political events shaping the public debate on public company auditing, as well as financial reporting and related regulatory and legislative issues.

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PCAOB

PCAOB issues annual report on broker-dealer inspections

The Public Company Accounting Oversight Board (PCAOB) on August 18 released its annual report on the progress of the interim inspection program for auditors of brokers and dealers registered with the Securities and Exchange Commission (SEC). The PCAOB began issuing annual progress reports on the interim program in August 2012.

The new annual report encompasses audits selected for inspection during 2014 that had financial statement periods ending on or before May 31, 2014. The PCAOB inspected 66 audit firms, reviewing portions of 106 audits of SEC-registered broker-dealers. Inspectors identified audit deficiencies at each of the selected firms and in 87 percent of the selected audits. They also identified independence findings in nearly one-quarter of the audits inspected.

The most frequent audit deficiencies were observed in the following areas:

- Revenue recognition;
- Reliance on records and reports;
- Fair value accounting estimates;
- Financial statement presentation and disclosures; and
- Audit procedures related to the customer protection rule

Independence findings included:

- Involvement in the preparation of the financial statements in 43 percent of the audits performed by 39 firms that audited broker-dealers but did not audit issuers;

- Involvement in the preparation of the financial statements in approximately six percent of the audits performed by 27 firms that audited broker-dealers and also audited issuers; and

- Engagement letters for four audits selected for inspection included clauses that would indemnify the auditor in the event the auditor incurred certain losses or liability in connection with the engagement.

The PCAOB also reported that, since it launched the interim inspection program, inspectors have identified audit deficiencies or independence findings in 87 percent of selected audits. Moreover, firms that did not also audit issuers had a higher percentage of audits with audit deficiencies or independence findings than the firms that also audited issuers. Firms that audited 100 or fewer broker-dealers also had a higher percentage of audits with audit deficiencies or independence findings than firms that audited more than 100 broker-dealers.

Looking ahead, the PCAOB said the staff is developing a proposal for the Board to consider during 2016 to establish a permanent inspection program.

PCAOB schedules Investor Advisory Group meeting

The PCAOB announced that its Investor Advisory Group (IAG) will meet on September 9. The agenda includes discussions of:

- An investor survey on matters the PCAOB should consider;
- Investor perspectives on certain PCAOB publications; and
- The auditor's evaluation of going concern.

The IAG also will discuss a May 29 letter from the U.S. Chamber of Commerce, in which the Chamber's Center for Capital Markets Competitiveness (CCMC) called for a meeting between the business community, PCAOB, and SEC "in order to address issues impacting internal controls and audits that may erode judgment and impair capital formation." In the CCMC's view, such a meeting should focus on three areas: management review controls, a "checklist" or "one-size-fits-all" approach, and materiality.

According to the CCMC, while the "business community believes that strong and effective internal controls and audits are an important component of the ability of businesses to communicate with investors in order to raise the capital needed to operate, grow, and compete…developments over the past several years have raised concerns that the unintended consequences of the PCAOB inspection process and corresponding changes to internal control processes are eroding judgment, as well as increasing costs and burdens for work that may in some instances not lead to more effective audits or controls. While accelerated filers are feeling the direct impacts, even non-accelerated filers are being affected."

The issue of management review controls is already on the SEC's agenda. Earlier this year, Deputy Chief Accountant Brian Croteau said the SEC staff was considering whether new guidance on management review controls was needed. The adequacy of such controls is "an ongoing issue with a frequent number of [PCAOB] inspection comments. It's not an area that seems to be improving. So why might that be? Is there something we could do to be more clear?"

The staff study will try to determine the reasons for an apparent disconnect between, on the one hand, how some companies apply the SEC's 2007 guidance on the Management's Report on Internal Control Over Financial Reporting and, on the other hand, how auditors respond to the requirements in Auditing Standard No. 5 and inspection findings. "There is an initial tendency among some to quickly suggest that PCAOB inspectors are driving auditors to perform work that is unnecessary," Croteau said. "While the inspection findings are, of course, one very visible factor to consider, it's only one of several factors in the equation. The SEC's interpretive guidance and AS5 are aligned in this area, so as a starting point I'd like to better understand examples of the types of facts and circumstances where the differences in views between management and auditors are most significant."

SEC

Federal court affirms decision on conflict minerals disclosure rule

The U.S. Court of Appeals for the District of Columbia Circuit (the Court) on August 18 affirmed its April 2014 decision striking down part of the SEC's conflict minerals disclosure rules. The rules, which the SEC adopted in August 2012, require public companies to publicly disclose their use of conflict minerals that originated in the Democratic Republic of the Congo (DRC) or an adjoining country.

The rule struck down by the Court would have required companies to disclose whether the covered minerals were found to be "DRC Conflict Free," "DRC Conflict Undeterminable," or "have not been found to be DRC Conflict Free." In its 2014 decision, the Court agreed with the plaintiffs' claim that requiring companies to publicly disclose which products "could not be found to be 'DRC conflict free'" constituted compelled speech and violated the First Amendment's free-speech protections.

The Court's affirmation has no immediate impact on the conflict minerals reporting requirements as currently in effect. Following the April 2014 decision, the SEC instructed companies that, in light of the decision, they would not be required to state "DRC Conflict Free," "DRC Conflict Undeterminable," or "have not been found to be DRC Conflict Free" in relation to their products.

SEC adopts rule for pay ratio disclosure

The SEC on August 5 adopted a final rule that requires a public company to disclose the ratio of the annual total compensation of its principal executive officer (PEO) to the median compensation of its employees. The new rule, which was mandated by the Dodd-Frank Act, requires disclosure of the pay ratio in registration statements, proxy and information statements, and annual reports that call for executive compensation disclosure. Companies will be required to provide the disclosure for their first fiscal year beginning on or after January 1, 2017.

The rule does allow companies some flexibility in developing the disclosure. In calculating the median employee compensation, for instance, the rule requires including both U.S. and non-U.S. employees. However, companies may exclude non-U.S. employees when foreign data privacy laws or regulations make companies unable to comply with the rule or when these employees account for five percent or less of the company's total U.S. and non-U.S. employees, with certain limitations. Also, the final rule allows companies to identify the median employee every three years, rather than every year.

Companies that cease to be smaller reporting companies or emerging growth companies (EGCs) are not required to provide pay ratio disclosure until they file a report for the first fiscal year commencing on or after they cease to be a smaller reporting company or EGC. The final rule also permits companies that engage in business combinations and/or acquisitions to omit the employees of a newly acquired entity from their pay ratio calculation for the fiscal year in which the business combination or acquisition occurs.

SEC adopts registration rules for security-based swaps

The SEC also adopted new rules to provide a process for security-based swap dealers and major security-based swap participants to register with the SEC. The new rules address all aspects of the registration regime for security-based swap dealers and major security-based swap participants, setting forth the extensive set of information required to be provided and kept up to date by a registrant. In addition, the rules require senior officers to make certifications about the registrant's policies and procedures for compliance with the federal securities laws at the time of registration. The rules take effect on October 13.

The SEC also proposed a rule of practice to create a process for security-based swap dealers and major security-based swap participants to apply to the SEC for permission to continue to have certain persons subject to statutory disqualifications involved in effecting their security-based swap transactions if such continuation is consistent with the public interest. The deadline for submitting comments is October 26.

FASB/IASB

FASB staff to draft final ASU on business combinations

The Financial Accounting Standards Board (FASB or Board) on August 5 discussed its proposed Accounting Standards Update (ASU), *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*, and made the following tentative decisions:

- The Board affirmed the proposal that an acquirer should recognize adjustments to provisional amounts in the reporting period in which the adjustment amount is determined and recognize the effects of changes in depreciation, amortization, or other income effects arising from changes to the provisional amounts, if any, in the income statement in the reporting period in which the adjustment to the provisional amount is determined. The Board also affirmed the proposal that acquirers should disclose the effect on current-period earnings, by line item, which would have been recognized in a previous period if the adjustment to provisional amounts had been recognized as of the acquisition date.

- The Board affirmed the proposal that acquirers should apply the changes prospectively to adjustments to provisional amounts identified after the effective date of the change that are within the measurement period.

- The Board decided the changes would be effective for pubic business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption for any interim and annual financial statements that have not yet been issued would be permitted. For all other entities, the Board decided that: (a) the changes should be effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after

December 15, 2017; and (b) early adoption would be permitted in any interim and annual financial statements that have not yet been made available for issuance.

The Board directed the staff to draft a final ASU for vote by written ballot.

FASB issues new, proposed ASUs

The FASB issued three new ASUs in August:

- ASU 2015-15, *Interest – Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements*, adds SEC paragraphs pursuant to the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting about the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements.

- ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, defers by one year the effective date of ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2015-14 defers the effective date of ASU 2014-09 for all entities by one year.

- ASU 2015-13, *Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception for Certain Electricity Contracts within Nodal Energy Markets*, specifies that the use of locational marginal pricing by an independent system operator does not constitute net settlement of a contract for the purchase or sale of electricity on a forward basis that necessitates transmission through, or delivery to a location within, a nodal energy market, even in scenarios in which legal title to the associated electricity is conveyed to the independent system operator during transmission. Consequently, the use of locational marginal pricing by the independent system operator does not cause that contract to fail to meet the physical delivery criterion of the normal purchases and normal sales scope exception. If the physical delivery criterion is met, along with all of the other criteria of the normal purchases and normal sales scope exception, an entity may elect to designate that contract as a normal purchase or normal sale. The amendments are effective immediately and should be applied prospectively.

The FASB also issued three proposed ASUs:

- Proposed ASU, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships*, would clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require de-designation of that hedge accounting relationship provided that all other hedge accounting criteria continue to be met. The deadline for submitting comments is October 5.

- Proposed ASU, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments*, would clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the proposed amendments would be required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. The deadline for submitting comments is October 5.

- Proposed ASU, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, would not change the core principle of the guidance in Topic 606; rather, the proposed amendments are intended to clarify the implementation guidance on principal versus agent considerations. The deadline for submitting comments is October 15.

International

IAASB proposes changes in reporting on summary financial statements

The International Auditing and Assurance Standards Board (IAASB) on August 3 released an Exposure Draft (ED) proposing changes to International Standard on Auditing (ISA) 810, *Engagements to Report on Summary Financial Statements*. ISA 810 deals with the auditor's responsibilities relating to an engagement to report on summary financial statements derived from financial statements audited in accordance with ISAs by that same auditor. The IAASB is proposing limited conforming amendments to ISA 810 as a result of the issuance of ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, in January 2015.

In particular, the proposed changes are intended to:

- Amend extant ISA 810 requirements to address the information gap related to a material uncertainty related to going concern and a material misstatement of other information.
- Introduce a new requirement for ISA 810 reports to include a reference to the communication of key audit matters in the auditor's report on the audited financial statements (i.e., to refer only to the existence of such communication without needing to describe, repeat, or otherwise refer to individual key audit matters).
- Align the layout of the ISA 810 illustrative auditor's reports in a manner consistent with those in ISA 700 (Revised).

The deadline for submitting comments on the ED is November 2.

CAQ Updates

CAQ comments on use of specialists, disclosure of certain audit participants

The Center for Audit Quality (CAQ) on July 31 submitted a comment letter on the PCAOB's *Staff Consultation Paper 2015-01 – The Auditor's Use of the Work of Specialists* (Consultation Paper). The Consultation Paper, which the PCAOB released in May, discussed the increase in the use and importance of specialists in recent years due, in part, to the increasing complexity of business transactions reported in a company's financial statements. It also raised questions about whether PCAOB standards adequately address the auditor's use of the work of specialists, and whether more rigorous standards and specific procedures are needed in this regard to help the auditor respond to the risks of material misstatement in financial statements.

According to the CAQ, potential amendments discussed in the Consultation Paper could affect certain aspects, or potentially rescind all, of AU sec. 336, *Using the Work of a Specialist* (AU336), and could affect certain aspects of Auditing Standard No. 10, *Supervision of the Audit Engagement* (AS10). The CAQ suggests that amendments related to the auditor's use of the work of specialists should, at a minimum: (1) align with the PCAOB's risk assessment standards; (2) include an evaluation of the impact of the potential enhancements on the existing standards related to accounting estimates, including fair value measurements; and (3) generally retain the principles in AU336.

Furthermore, the CAQ recommends that any enhancements to the existing auditing standards should be principles-based and recognize the relationship between the auditor's risk assessment and the audit procedures designed to sufficiently and appropriately respond to those risks. Enhancements also should allow for auditors of issuers of different complexities and compositions to apply the auditing standards consistently, without limitations or restrictions.

On August 28, the CAQ submitted a comment letter on the PCAOB's *Supplemental Request for Comment: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form* (Supplemental Request). The Supplemental Request sought comments on whether to require firms to file a new form – Form AP, *Auditor Reporting of Certain Audit Participants* – to make public the name of the audit engagement partner and information about certain other participants in the audit. The PCAOB is considering Form AP as a potential alternative to the proposal to promote audit transparency by providing these disclosures in the auditor's report.

According to the CAQ, identifying the engagement partner and certain other audit participants in Form AP, rather than in the auditor's report, would avoid the potential challenges in obtaining consents from the engagement partner and certain other participants in the audits. Disclosing this information in Form AP also would facilitate effective and efficient access of this information by investors and other stakeholders.

The CAQ suggests, however, that there would be benefits if the PCAOB provided additional clarity and implementation guidance on disclosures related to these audit participants, particularly as it relates to the ability to use estimates when determining each firm's level of participation. Additionally, adjusting the filing deadline and having additional time to implement those disclosure requirements would allow audit firms to address many of these challenges.

CAQ releases new 'Profession in Focus' video

The CAQ on August 18 released the fifth episode of its online video series, *Profession in Focus*. In this episode, Stephen R. Howe, Jr., Americas Managing Partner and Managing Partner at EY U.S., shares reflections on auditing, governance, and diversity, including how striving for diversity benefits his firm.

The video series is archived on the CAQ website.

Catherine Nance Joins the CAQ as Senior Director of Professional Practice

The CAQ on August 10 announced that Catherine Nance joined the organization as Senior Director of Professional Practice. In her new role, Nance will play a pivotal role in leading the CAQ's regulatory and public policy initiatives and activities.

Nance comes to the CAQ from the global law firm of Fragomen, Del Rey, Bernsen & Loewy where she served as Director of Audit. In that role, she helped create the firm's internal audit and compliance function. She also developed and launched their global practice review audit plan at 46 offices worldwide. Previously, she was in PwC's audit practice from 1997 to 2013, most recently as a Senior Manager in the Chief Auditor Network where she provided auditing advice and technical guidance on auditing standards, policies, and methodologies at the local engagement level, particularly related to areas of internal and external inspection findings.

Upcoming Events

September 9
PCAOB Investor Advisory Group Meeting, Washington, DC (Link)

September 16-18
AICPA National Conference on Banks & Savings Institutions, Washington, DC (Link)

September 21-25
IAASB Board Meeting, New York, NY (Link)

September 24
PCAOB Forum for Auditors of Broker-Dealers, Jersey City, NJ (Link)

September 26-29
NACD Global Board Leaders' Summit, Washington, DC (Link)

September 27-30
ICI Tax and Accounting Conference, Orlando, FL (Link)

September 30
ICGN Boston Event, Boston, MA (Link)

September 30-October 2
CII Fall Conference, Boston, MA (Link)

October 6
U.S. Chamber of Commerce Cybersecurity Summit, Washington, DC (Link)

October 6
PCAOB Forum on Auditing in the Small Business Environment, Pittsburgh, PA (Link)

Oct 22-23
PCAOB Conference on Auditing and Capital Markets, Washington, DC (Link)

October 25-28
NASBA Annual Meeting, Dana Point, CA (Link)

October 28
PCAOB Forum for Auditors of Broker-Dealers, West Palm Beach, FL (Link)

October 29
PCAOB Forum on Auditing in the Small Business Environment, West Palm Beach, FL (Link)

November 5
ICI Cybersecurity Forum, Washington, DC (Link)

November 12-13
PCAOB Standing Advisory Group Meeting, Washington, DC (Link)

November 16-17
PLI Annual SEC Reporting and FASB Forum, Dallas, TX (Link)

December 1
PCAOB Forum for Auditors of Broker-Dealers, Las Vegas, NV (Link)

December 2
PCAOB Forum on Auditing in the Small Business Environment, Las Vegas, NV (Link)

December 3-4
PLI Annual SEC Reporting and FASB Forum, New York, NY (Link)

December 7-8
AICPA Employee Benefit Plans Accounting, Auditing and Regulatory Update, Washington, DC (Link)

December 7-11
IAASB Board Meeting, New York, NY (Link)

December 9-11
AICPA Conference on Current SEC and PCAOB Developments, Washington, DC (Link)

December 14-15
PLI Annual SEC Reporting and FASB Forum, San Francisco, CA (Link)

The Center for Audit Quality is an autonomous, nonpartisan, nonprofit organization dedicated to enhancing investor confidence and public trust in the global capital markets by fostering high-quality public company audits; collaborating with other stakeholders to advance the discussion of critical issues; and advocating policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of CPAs. For more information, visit www.thecaq.org.

The CAQ Public Policy Monitor represents the observations of the CAQ, but not necessarily the views of particular member firms, Governing Board members or individuals associated with the CAQ. Questions and comments about the CAQ Public Policy Monitor can be addressed to: ppm@thecaq.org.