34th Annual
SEC and Financial Reporting
Institute Conference

June 5, 2015
Langham Huntington Hotel
Pasadena, California
SEC and Financial Reporting Institute Conference
June 5, 2015

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Morning Sessions

7:30 - 8:20  Registration and Continental Breakfast

8:20 - 8:30  Welcome and Introductions

Lori L. Smith  
Director, SEC and Financial Reporting Institute and  
Assistant Professor of Clinical Accounting  
USC Leventhal School of Accounting

William W. Holder  
Dean, Leventhal School of Accounting and  
Alan Casden Dean’s Chair in Accounting  
USC Leventhal School of Accounting

8:30 - 9:15  Opening Addresses by Chief Accountant of the SEC and Vice Chair of the FASB

James V. Schnurr  
Chief Accountant  
Office of the Chief Accountant  
U.S. Securities and Exchange Commission

James L. Kroeker  
Vice Chairman  
Financial Accounting Standards Board

9:15 - 10:30  Emerging Issues in Financial Disclosure, Disclosure Reform and Effectiveness

MODERATOR: Lori L. Smith  
Director, SEC and Financial Reporting Institute and  
Assistant Professor of Clinical Accounting  
USC Leventhal School of Accounting

PANELISTS:  
DawnDee F. Hankel  
External Reporting Controller  
Intel Corporation

Mark Kronforst  
Chief Accountant  
Division of Corporation Finance  
U.S. Securities and Exchange Commission

Robert Uhl  
National Director of Accounting Standards and Communications  
Deloitte & Touche LLP

10:30 - 10:45  Refreshment Break

10:45 - 12:15  Internal Control Over Financial Reporting - Why the Renewed Focus by Everyone? Perspectives from the SEC, PCAOB, Auditors and the Issuers

MODERATOR: John W. White  
Partner  
Cravath, Swaine & Moore LLP

PANELISTS:  
James G. Campbell  
Vice President of Finance and Corporate Controller  
Intel Corporation

Jeanette M. Franzel  
Board Member  
Public Company Accounting Oversight Board

Michael J. Gallagher  
Managing Partner, Assurance Quality  
PricewaterhouseCoopers LLP

James V. Schnurr  
Chief Accountant  
Office of the Chief Accountant  
U.S. Securities and Exchange Commission
SEC and Financial Reporting Institute Conference
June 5, 2015

PROGRAM

Afternoon Sessions

12:30 - 2:00  Luncheon and Keynote Presentation
A Conversation with Jeannette Franzel, PCAOB Board Member

INTRODUCTION:  Roger Molvar
Board Member
PacWest Bancorp

LUNCHEON PRESENTATION:  Dennis R. Beresford
Executive Professor of Accounting
J.M. Tull School of Accounting
University of Georgia

Jeanette M. Franzel
Board Member
Public Company Accounting Oversight Board

2:15 - 3:45  Leases and Financial Instruments - Planning for What’s Next

MODERATOR:  Norman N. Strauss
Ernst & Young Executive Professor in Residence
CUNY - Baruch College

PANELLISTS:
John Bishop
Partner, Accounting Services Group
PricewaterhouseCoopers LLP

Susan M. Cosper
Technical Director, Financial Accounting Standards Board
Chairman, Emerging Issues Task Force

Bret Dooley
Managing Director and Director of Corporate Accounting Policies Group
JPMorgan Chase & Co.

4:00 - 5:30  Revenue Recognition - Getting Ready to Adopt

MODERATOR:  Norman N. Strauss
Ernst & Young Executive Professor in Residence
CUNY - Baruch College

PANELLISTS:
DawnDee F. Hankel
External Reporting Controller
Intel Corporation

Alison T. Spivey
Partner, Assurance Services - National Accounting
Ernst & Young LLP

James L. Kroeker
Vice Chairman
Financial Accounting Standards Board

Scott A. Taub
Managing Director
Financial Reporting Advisors, LLC

3:45 - 4:00  Refreshment Break

5:30 - 6:30  Reception
SEC and Financial Reporting Institute Conference
June 5, 2015

SPEAKERS

Dennis R. Beresford
Executive Professor of Accounting
J.M. Tull School of Accounting
University of Georgia

John Bishop
Partner, Accounting Services Group
PricewaterhouseCoopers LLP

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Managing Director
Financial Reporting Advisors, LLC

Amie Thuener
Chief Accountant
Google, Inc.

Robert Uhl
Partner
National Director of Accounting Standards and Communications
Deloitte & Touche LLP

John W. White
Partner
Cravath, Swaine & Moore LLP
Dennis R. Beresford is Executive in Residence at the J. M. Tull School of Accounting, Terry College of Business, University of Georgia. From July 1997 through June 2013 he was Ernst & Young Executive Professor of Accounting. From January 1987 through June 1997 he was chairman of the Financial Accounting Standards Board. Previously, he was national director of accounting standards for Ernst & Young. He is a graduate of the University of Southern California.

Denny is a director and chairman of the audit committee of Doosan Infracore International, Inc. He previously served on the boards of National Service Industries, Inc., WorldCom (MCI), Inc., Kimberly-Clark Corporation, Fannie Mae, and Legg Mason, Inc. He is also a member of the board of directors of the National Association of Corporate Directors, the Public Company Accounting Oversight Board Standing Advisory Group, and the Financial Reporting Committee of the Institute of Management Accountants.

In 1995, Denny was awarded an honorary Doctor of Humane Letters degree from DePaul University. In 2004 he was elected to the Accounting Hall of Fame and received the AICPA Gold Medal for distinguished service. In 2006 he was selected as one of the inaugural inductees of Financial Executives International’s Hall of Fame. In 2012 the Journal of Accountancy named him as one of the “125 people of impact in accounting,” as among those who have had the most impact on the accounting profession since the AICPA was founded in 1887. In 2013 he received the Institute of Management Accountants’ first Distinguished Member Award.
John Bishop
Partner, Accounting Services Group
PricewaterhouseCoopers LLP

John is currently the co-leader of the Financial Instruments team within the Accounting Services Group of PwC’s National Office. In that role he leads the group in advising the firm’s clients on a wide array of accounting and reporting matters. John is one of the firm’s experts in the accounting for derivatives, financial instruments, financing transactions (i.e. securitizations and leasing), consolidation and foreign currency matters. He has worked with and advised a variety of the firm’s clients including investment banks, commercial banks, private equity firms and companies in the merchant power, utility, real estate and retail industries.

Prior to his national office role, John served as the senior technical partner for the firm’s Capital Markets Accounting Advisory Services Practice (CMAAS). This is a specialty practice that assists clients in dealing with accounting and reporting matters related to transactions and capital markets events. The group specializes in providing advice around financial instrument issues such as derivatives and hedging, financing arrangements and fair value measurements. Other areas of specialty are leasing, share based payments and advice around structuring joint ventures, leveraged recapitalizations, and other investment and acquisition events.

John holds a BBA in accounting from Hofstra University and an MBA in finance from New York University.

John is a licensed CPA in the states of New York and New Jersey.
James G. Campbell is vice president of Finance and corporate controller at Intel Corporation. He is responsible for global accounting, financial services and financial reporting. Campbell also leads and manages the international controllers responsible for financial services, statutory compliance and business support. Campbell joined Intel in 1981.

Previously, Campbell was based in Europe, responsible for Intel’s international finance operations. He has also been manager of Intel’s Financial Information Systems, responsible for designing, developing and implementing Intel’s internally used financial applications. In addition, he has served as Asia regional audit manager, Microprocessor Group Controller and European controller. Before joining Intel, Campbell worked for Itel Corporation.

Campbell received his bachelor’s degree in business and accounting from California State University, Hayward. He holds a CPA license and is a member; of the Financial Executives Committee on Corporate Reporting (CCR), the Executive Committee of CCR, the FASB Emerging Issues Task Force (EITF), the PCAOB Standing Advisory Group (Emeritus), the Portland State University Graduate School of Business Advisory Board and serves on the Board of Trustees Portland Chapter of World Affairs Council.
Susan M. Cosper is the FASB technical director and Chairman of the emerging Issues Task Force, a role she has held since February 1, 2011. Ms. Cosper has responsibility for managing all FASB’s technical projects and activities. Ms. Cosper has more than 22 years of diverse financial reporting and auditing experience. Prior to her appointment at the FASB, she was a partner with PricewaterhouseCoopers LLP (PwC). Ms. Cosper joined the Pittsburgh office of PricewaterhouseCoopers in 1992, where she performed audits of private and public companies in PwC’s Assurance practice. From 1998 to 2001, she accepted an international assignment in the Firm’s London office. There, she led global audit engagements and advised clients on international accounting issues. After her return to Pittsburgh, in 2005 she was selected for a three-year fellowship with the FASB, where she held the roles of practice fellow and senior practice fellow. Upon completing the fellowship, she became part of PwC’s national office and, served in PwC’s Financial Instruments, Structured Products, and Real Estate Group in New York City. She earned her B.S. in accounting from Indiana University of Pennsylvania and is a certified public accountant in the states of New York, New Jersey, and Pennsylvania.
Bret Dooley is the Director of the Corporate Accounting Policies Group at JPMorgan Chase. The Corporate Accounting Policies Group defines and maintains global accounting policies for the Firm and consults on their application, provides accounting guidance on specific complex transactions and products, and interfaces globally with standard setters and regulators on accounting matters. Bret is a member of the FASB’s Emerging Issues Task Force, as well as a variety of accounting committees and organizations.

Prior to joining JPMorgan Chase, he spent several years at Citi, where he was managing director in accounting policy for the Institutional Clients Group. He began his career at Arthur Andersen, most recently in that firm’s national office, the Professional Standards Group. In that role he consulted with clients and engagement teams on complex accounting issues involving financial instruments, securitizations and derivative instruments, and assisted in the development and authoring of the firm’s guidance on those matters.

Mr. Dooley earned an MBA degree with high honors from the University of Chicago Booth School of Business, concentrating in Analytic Finance, and graduated summa cum laude from the University of Notre Dame with a BBA degree in Accountancy.
Jeanette M. Franzel was appointed by the Securities and Exchange Commission as a member of the Public Company Accounting Oversight Board in February 2012.

The PCAOB’s mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest through high quality independent, and reliable audits. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

The Board has oversight of PCAOB’s operations including the four primary responsibilities under Title I of the Sarbanes-Oxley Act: (i) registration of accounting firms; (ii) inspections of registered firms’ audits and quality control; (iii) establishment of auditing and related attestation, quality control, ethics, and independence standards; and (iv) investigation and discipline of registered public accounting firms and their associated persons for violations of specified laws or professional standards.

Prior to joining the PCAOB, Ms. Franzel served nearly 23 years at the Government Accountability Office (GAO), ending her tenure as a Managing Director overseeing all aspects of the organization’s financial audit oversight of the U.S. federal government. During a decade in GAO’s Senior Executive Service, she supervised audits for large complex agencies as well as small programs with limited resources.

From 2008 through 2011, Ms. Franzel's team performed oversight of the U.S. government's efforts to help stabilize the financial markets and promote economic recovery.

From 2003 to 2012, Ms. Franzel oversaw the periodic updating and issuing of GAO's Government Auditing Standards ("The Yellow Book") which is used throughout the world. She also provided extensive policy and technical support to the International Organization of Supreme Audit Institutions which develops auditing standards for national audit offices around the world.
Jeanette M. Franzel
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In 2011, Ms. Franzel was the recipient of GAO's Distinguished Service Award and the AICPA's Outstanding CPA in Government Award. In 2010, she received the International Achievement Award from the Association of Government Accountants.

Prior to her career in accounting and auditing, Ms. Franzel taught elementary school and high school in South America.

Ms. Franzel has a B.A. in Accounting and Spanish from the College of St. Teresa as well as an MBA from George Mason University. She also completed the Senior Executive Fellows program at Harvard University. Ms. Franzel is a certified public accountant, a certified internal auditor, a certified management accountant, and a certified government financial manager.
As PwC's Managing Partner, Assurance Quality, Mike leads PwC's U.S. Assurance National Office (National Office). National Office functions include: Accounting Services; SEC Services; Risk Management; Strategic Thought Leadership; and Auditing Services Methods and Tools. He is also responsible for PwC's Learning & Development, Regulatory Relations, and Inspections groups.

Mike has more than 28 years of public accounting experience. His previous National Office roles and leadership positions include serving as: PwC's U.S. Chief Accountant; U.S. Risk Management Leader; and National Office Accounting Consulting Partner. Prior to joining the National Office, Mike served as a Global Engagement Partner on a number of multinational SEC registrants focused primarily in the chemical/industrial products sector.

Mike served on PwC's US Board of Partners and Principals, including the Finance, Governance, and Clients and Strategy committees.

He is a member of the Public Company Accounting Oversight Board's (PCAOB) Standing Advisory Group (SAG) and Chairman of the Center for Audit Quality's (CAQ) Professional Practice Executive Committee (PPEC). Mike is also a frequent speaker at profession related events and a member of the AICPA and Pennsylvania Institute of CPAs.
DawnDee F. Hankel
External Reporting Controller
Intel Corporation

DawnDee Hankel is currently the External Reporting Controller for Intel, supporting Intel’s financial reporting cycles and earnings release processes. She has held several positions across Intel Finance during her 15 years at the company including Accounting Policy, Treasury Accounting and Operations Finance. Prior to joining Intel, she spent 5 years in the Portland, Oregon office of PricewaterhouseCoopers LLP in the audit practice supporting consumer products and technology clients.
William W. Holder
Dean, Leventhal School of Accounting and
Alan Casden Dean’s Chair in Accounting
USC Leventhal School of Accounting

William Holder serves as Dean of the USC Leventhal School of Accounting, and holds the Alan Casden Dean’s Chair of Accountancy. Prior to his current post, Dean Holder was the Ernst & Young Professor of Accounting and Director of the SEC and Financial Reporting Institute in the Marshall School of Business at the University of Southern California. He is an expert on financial reporting and auditing. Dean Holder has published extensively on these subjects and received numerous awards during his career, including being twice named as one of the “Top 100 People” in the accounting profession and receiving the AICPA Gold Medal for Distinguished Service, the highest honor awarded by that organization. He has served on a number of governance and standard setting authorities including the Accounting Standards Executive Committee of the AICPA and the Governmental Accounting Standards Board. During Congressional hearings leading to passage of the Sarbanes/Oxley Act, he provided invited testimony about financial reporting, auditing and corporate governance.
James L. Kroeker was appointed a member and vice chairman of the Financial Accounting Standards Board (FASB) on September 1, 2013. In the latter role, he assists the FASB chairman in representing the Board to external stakeholders and in conducting its internal operations, in addition to serving as a voting member of the Board.

Mr. Kroeker joins the FASB from Deloitte, where he served as the Deputy Managing Partner for Professional Practice. Prior to joining Deloitte in January 2013, he served as the Chief Accountant of the Securities and Exchange Commission from January 2009 until his departure in 2012. In this capacity, Jim served as the senior accounting professional for the Commission and the principal advisor to the Commission on all accounting and auditing matters. In his capacity at the SEC, he was responsible for resolution of a wide range of globally significant accounting and auditing issues.

Since joining the Commission in February 2007, Jim played a key role in efforts to improve the transparency and reduce the complexity of financial disclosure. He served as staff director of the SEC's Congressionally-mandated study of fair value accounting standards, and he has led the efforts of the Office of the Chief Accountant to address the economic crisis, including steps to improve off-balance sheet accounting guidelines. Jim also served as the Designated Federal Officer responsible for the staff oversight of the SEC's Advisory Committee on Improvements to Financial Reporting. He also was responsible for the day-to-day operations of the office, including resolution of accounting and auditing practice issues, rulemaking, and oversight of the FASB and PCAOB.

Prior to joining the SEC, Jim was a partner at Deloitte in the firm's Professional Practice Network and was responsible for providing consultation and support regarding the implementation, application, communication and development of accounting standards, including disclosure and reporting matters. Jim was Deloitte & Touche’s representative on the AICPA Accounting Standards Executive Committee (AcSEC). He also served as a Practice Fellow at the Financial Accounting Standards Board.

Jim received a Bachelor of Science degree with an emphasis in accounting from the University of Nebraska in May 1992.
Mark Kronforst
Chief Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission

Mark Kronforst is the Chief Accountant in the Division of Corporation Finance at the U.S. Securities and Exchange Commission. Mark’s previous roles in the Division include Associate Director – Disclosure Operations and Deputy Chief Accountant. He joined the Division as a Staff Accountant in 2004. Before joining the Division, Mark worked for a large SEC registrant as the Director of Financial Reporting and as an audit senior manager in KPMG’s Silicon Valley and Minneapolis offices.
Roger H. Molvar serves as a director and member of the audit and the compensation, nominating, and governance committees of PacWest Bancorp, the largest independent bank headquartered in Los Angeles. In 2014, CapitalSource Bank merged with PacWest Bank in what was described as one of the top value creating banking transactions of the year. At CapitalSource Bank, Roger was a founding director and chair of both the audit and the risk management committees. Prior board service includes Farmers & Merchants Bank, La Opinión Media, and numerous civic and non-profit entities.

From 2000 to 2004, Roger was chief executive officer of IndyMac Consumer Bank and previously, was an executive officer and management committee member of The Times Mirror Company, which was acquired by media giant Tribune Co. in 2000.

Roger is chairman of the SEC and Financial Reporting Institute at the University of Southern California. He is an active participant in the West Audit Committee Network, which facilitates discussions on enhancing corporate governance, and serves on the Editorial Advisory Board of the AICPA’s Journal of Accountancy. He received his undergraduate degree in business administration from the University of Washington and is a graduate of the Graduate School of Financial Management at Dartmouth and the Stanford University Advanced Management College.
James V. Schnurr
Chief Accountant
Office of the Chief Accountant
U.S. Securities and Exchange Commission

Jim Schnurr was recently named Chief Accountant of the Securities and Exchange Commission. Prior to taking on the role of Chief Accountant of the SEC, Jim Schnurr was one of Deloitte LLP’s most senior client service partners, serving some of the firm’s largest and most complex clients. As vice chairman and senior national professional practice director from 2009 to his retirement in 2014, he was a specialist in mergers and acquisitions and financial and SEC reporting. A partner since 1985, Jim has been one of the most respected accounting professionals inside and outside Deloitte for the last twenty years.

Jim served as the advisory partner on Fannie Mae, Rockwood Holdings, TE Connectivity and Schering Plough. Jim also provided financial reporting advice and consultation to the firm’s largest financial services clients including, Blackstone Group, KKR, BlackRock, Morgan Stanley, Apollo Group Management and Lazard.

Earlier in his career, Jim’s deep expertise in accounting and SEC reporting matters lead to his appointment to lead Deloitte’s accounting consultation group and ultimately assume leadership of Deloitte’s national office. In this role, Jim was responsible for the system of quality control and risk management of the firm’s audit and advisory businesses and had primary responsibility for interacting with the SEC and PCAOB as it relates to their oversight and regulation of Deloitte’s audit practice.

Jim has broad industry experience from his eight years working in the firms Mergers & Acquisitions group and as a lead client service partner for 5 years. Jim has provided due diligence and structuring advice on more than 100 transactions serving both strategic and financial buyers and sellers. Clients served include Penn Central Corporation, Cendant and many of the largest private equity firms.

Jim has extensive experience with companies that have been spun off from the parent company including the spinoffs from Tyco and Cendant.

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James V. Schnurr
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Jim’s calm and forthright communication style and valuable insights on accounting and SEC reporting and risk management issues has earned him the respect of his colleagues in Deloitte, as well as, with standard setters, regulators and clients. His ability to quickly analyze complex transactions and explain them to others in lay man’s terms has allowed him to effectively communicate with and reconcile differing views among the board, management, auditors and regulators. He is frequently requested to assist clients in addressing their most complex and challenging financial reporting issues.

Jim is a certified public accountant licensed in Connecticut and a member of the American Institute of Certified Public Accountants (AICPA) and the Connecticut Society of Certified Public Accountants. He has served on various working and advisory groups of the Financial Accounting Standards Board, the Public Company Accounting Oversight Board and the AICPA.

Jim received his BA from The College of the Holy Cross and an MBA from Rutgers University.
Lori L. Smith
Director
SEC and Financial Reporting Institute
Assistant Professor of Clinical Accounting
USC Leventhal School of Accounting

Lori Smith has nearly 30 years of expertise in accounting, financial reporting, internal control and management both as a company executive of a Fortune 500 public company and as an audit and assurance partner with Deloitte & Touche LLP.

Lori is a professor at the USC Leventhal School of Accounting where she focuses on financial reporting for public companies and accounting ethics. She also serves as the Director for the SEC and Financial Reporting Institute.

Lori graduated from the University of Southern California with a B.S. degree in Accounting and is a certified public accountant, licensed in California.
Alison T. Spivey is a partner in Professional Practice – National Accounting at Ernst & Young LLP. In this position, Alison is responsible for consulting with engagement teams on technical accounting and reporting matters, monitoring activities of standard-setting bodies, drafting firm communication materials related to new and existing accounting pronouncements and leading professional education courses, primarily in the subject areas of revenue recognition and compensation arrangements. Alison is a member of the FASB/IASB Joint Transition Resource Group for revenue recognition.

Prior to joining Ernst & Young's National Professional Practice, Alison spent over four years in the Office of the Chief Accountant of the U.S. Securities and Exchange Commission. As an Associate Chief Accountant, her responsibilities included working with public registrants on accounting and reporting matters, acting as a liaison with professional accounting standard-setting bodies, and participating in the development of the Commission staff's guidance and rule proposals under Federal Securities laws. Alison consulted with registrants on technical accounting matters and was a co-author of Staff Accounting Bulletin No. 107, Share-Based Payment.

Alison also spent one year as a Professional Accounting Fellow and staff accountant in the Division of Corporation Finance of the U.S. Securities and Exchange Commission reviewing the disclosure documents of public companies.

Alison is a graduate of The College of William and Mary and is a Certified Public Accountant licensed to practice in Virginia, Washington, D.C., and New York.
Norman Strauss retired as a partner at Ernst & Young LLP in 2001 and then began his second career as E&Y’s Executive Professor in Residence at Baruch College in New York teaching contemporary accounting in the graduate school. He has recently retired from actively teaching but he will continue to chair Baruch’s annual Financial Reporting Conference which is one of the major accounting conferences in the US.

Norm has been E&Y’s National Director of Accounting Standards and a member of the firm’s Accounting and Auditing Committee. He also was Ernst & Young’s representative on the FASB’s Emerging Issues Task Force and the Financial Accounting Standards Advisory Council. He was Baruch’s and E&Y’s Representative on the Advisory Council for the International Accounting Standards Board. In addition, Norm has previously served as Chairman of the AICPA’s Accounting Standards Executive Committee (AcSEC) and as Chairman of the Audit Committee of the Federal Farm Credit Banks Funding Corporation.

Norm is also a member of the Financial Reporting Committee of the Institute of Management Accountants. He has an MBA and BBA from Baruch College. He is a frequent lecturer at various seminars, has chaired Baruch’s financial reporting conferences since inception in 2002, and has been published in professional journals including the Journal of Accountancy.
Scott A. Taub is a Managing Director of Financial Reporting Advisors, LLC (FRA). Based in Chicago, Illinois, FRA provides consulting services related to accounting and SEC reporting. FRA specializes in applying generally accepted accounting principles to complex business transactions, offering clients an unbiased assessment of the accounting literature as applied to their situation. FRA also provides litigation support and expert services, and FRA’s partners participate in activities to improve financial reporting and the capital markets.

Mr. Taub is the author of the *Revenue Recognition Guide*, a 600-page comprehensive guide published by CCH, and a co-author of CCH’s *Financial Instruments: A Comprehensive Guide to Accounting and Reporting*. He is a member of the FASB/IASB Joint Transition Resource Group for Revenue Recognition. Mr. Taub was a member of the IFRS Interpretations Committee from 2008-2014, and was an original member of the Financial Accounting Standards Board (FASB) Valuation Resource Group. Mr. Taub writes a periodic column for Compliance Week on financial reporting developments.

From September 2002 through January 2007, Mr. Taub was a Deputy Chief Accountant at the Securities and Exchange Commission (SEC). He twice served as Acting Chief Accountant for a total of 14 months. He played a key role in the SEC’s implementation of the accounting reforms under the landmark Sarbanes-Oxley Act, and was responsible for the day-to-day operations of the Office of the Chief Accountant, including resolution of accounting and auditing practice issues, rulemaking, oversight of private sector standard-setting efforts, and regulation of auditors.

Mr. Taub represented the SEC in many venues, including advisory committees of the FASB and International Accounting Standards Board (IASB), and in front of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. He also served as the SEC Observer to the FASB’s Emerging Issues Task Force (EITF) and as Chair of the Accounting and Disclosure committee of the International Organization of Securities Commissions (IOSCO). Mr. Taub also was a member of the SEC staff between 1999 and 2001 as a Professional Accounting Fellow.
Scott A. Taub
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Prior to September 2002, Mr. Taub was a partner in Arthur Andersen’s Professional Standards Group (PSG). In that role, he consulted on complex financial reporting matters; helped establish and disseminate Andersen’s policies regarding financial reporting matters; and represented the firm before standards setters and regulators. Mr. Taub consulted and authored interpretive guidance for Andersen on a wide variety of reporting issues, including revenue recognition, business combinations, compensation arrangements, intangible assets, impairment and investment accounting. Prior to joining the PSG, he was member of the audit practice in the firm’s Detroit office serving publicly held and privately owned companies in a variety of industries.

Mr. Taub is a frequent speaker, having addressed numerous audiences sponsored by a variety of organizations such as the Financial Executives International, the AICPA, the Institute of Management Accountants, the Securities Regulation Institute, and the Practising Law Institute. He was the primary author of several SEC reports and publications, including the Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers and the Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.

Mr. Taub received an undergraduate degree in economics in 1990 from the University of Michigan in Ann Arbor. He won the William A. Paton Award for his performance on the CPA exam. In 2005 Mr. Taub won the SEC’s award for Supervisory Excellence. He is a licensed CPA in Michigan and Illinois.
Amie Thuener is the Chief Accountant at Google leading Google’s SEC Reporting, Accounting Policy, and M&A Finance and Integration teams, as well as the Treasury Controller covering accounting, reporting and policy related to all Google’s finance and hedging activities. Prior to Google, Amie was a Managing Director in PricewaterhouseCooper’s Transaction Services Group where she served clients of all sizes and in a variety of industries, providing accounting consulting services. Over the course of her 16 year tenor with PwC, Amie worked in the audit practice in San Francisco, spent two years at the firm’s National office, and worked in the firm's Transaction Services practice in New York and San Jose. Amie was also a Practice Fellow at the Financial Accounting Standards Board from 2004 to 2006, where she worked on projects such as Revenue Recognition and Fair Value Measurements.

Amie graduated from UC Santa Barbara with a degree in Business Economics and Philosophy. She is a CPA in California and New York and a Chartered Global Management Accountant.

Amie also serves as the Treasurer on the Girls Leadership Institute’s Board of Directors, a national organization that teaches girls the skills to know who they are, what they believe, and how to express it, empowering them to create change in their world. Amie has also served as Treasurer on the Board of Concrete Safaris, a New York based organization that empowers youth to be healthy leaders through green exercise programs that enrich the mind, body, community and environment.

In her spare time, Amie loves to spend time with her three small kids and her husband in Tahoe - skiing in the winter and swimming in the Donner Lake in the summer. She also loves to cook and travel.
Robert Uhl
Partner
National Director of Accounting Standards and Communications
Deloitte & Touche LLP

Bob Uhl is a Partner at Deloitte & Touche LLP and National Director of Accounting Standards and Communications. Bob is also the U.S. leader on Deloitte’s Global IFRS Leadership Team. His responsibilities include formulating policies on accounting matters under both US and international accounting standards, and communicating with accounting standard setters, Deloitte professionals, clients and other parties interested in financial reporting. He has also previously had roles in Deloitte’s Accounting Consultation Group and Stamford, Connecticut audit practice.

Bob is a member of the Financial Accounting Standard Board’s Emerging Issues Task Force, a member of the International Accounting Standard Board’s Financial Instrument Working Group, and actively participates in a number of other standard setter forums. He previously served as a member of the AICPA’s Accounting Standards Executive Committee. Bob is also a member of several committees with a financial reporting focus.

While most of Bob’s career has been at Deloitte, he has also been a managing director in the accounting policy group of Goldman, Sachs & Co. and a Professional Accounting Fellow in the Office of the Chief Accountant of the Securities and Exchange Commission.

Bob graduated from the University at Albany in 1987 with a B.S. degree in Accounting.
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Leases –
Are They Going on the Balance Sheet?

Current leasing rules - a mess! - Complex, rules based, arbitrary (75% test), structured transactions resulting in off-balance sheet financing.

Otherwise ... rules are fine!

FASB’s (and IASB’s) answer … Yes!

Two proposals have been debated for years now and the final standard is almost ready to go!
Leases – The Solution

Put virtually *all* leases on the Balance Sheet

**Lessee** - The right to use is an asset! Non-cancellable obligation is a liability!

**Lessor** - Similar to today’s rules

FASB & IASB are close together - convergence?  
**YES** (sort of) for the balance sheet  
but **NO** for the income statement!

What is the Standard for Lessees?

Lessees should put noncancellable leases on the balance sheet - the primary objective of the whole project!

- Exception - Use operating lease accounting for leases of 12 months or less (IASB exception - “small assets”)

- What about renewal options (big issue)? For determining the term of the lease (including the 12 month exception) - include option only if it is “reasonably certain to be exercised” - a high threshold!

And what about the income statement?
Amortizing the Right to Use Asset?

The controversy - Using the S/L method to amortize the asset and the effective interest method for the liability for all leases would result in higher up-front expense (interest and amortization) than operating lease accounting - Does this make sense for all leases?

FASB and IASB could not agree so income will differ but both will put an asset and liability on the balance sheet.

Type A and B Leases

FASB picked a dual model:
- **Type A** - financing leases - record interest and amortization separately like a capital lease today
- **Type B** - record straight line total lease expense like an operating lease today

IASB picked a single model:
- **All** are financing leases (Type A) [oh well!]
A vs B - That is the Question!

Use an IASC 17 principles based, substance over form approach. Has substantially all risks and rewards passed to lessee? [Yes=A; No=B]

Consider -
Will title pass, is there a “bargain” purchase option, is term a major part of life, does present value of payments amount to substantially all of the asset’s FV? Similar to FAS 13 but without the red lines. [This may not cause a change in today’s classification practices]

Maybe we should keep the red lines (75%, 90%)?

The Methods - Example (a test!)

5 yr lease  $250 per yr  Total rent $1,250  A&L $1,000  PV@8%

Type A - an interest and amortization approach
Year 1: Principal ($250 rent - $80 interest = $170 principal) $170
Interest ($1,000 @ 8%) $80
Amortization of asset ($1,000 / 5 yrs) 200
Expense in Year 1 (like a capital lease) $280

Type B - a straight line expense approach
Year 1: Expense straight line ($1,250 / 5 yrs) (like an operating lease) $250

The $30 difference ($280-$250) will reverse by the end of the lease

So how do you balance the books?
The Bookkeeping

**Type A** - Same as capital lease accounting
End of Year 1: Asset = $800 | Liability = $830

**Type B** - Straight line approach
Use the interest method for the liability BUT measure the Right to Use asset as a balancing figure to make total expense the same as S/L (some would call this the “plug”)

End of Year 1: Asset = $830 | Liability = $830
   Liability = $830 = $1,000 - $170 principal
   Total Expense = $250 = $80 interest + $170 amortization
   Just like old operating lease accounting on the income statement

FASB and IASB balance sheets are now different at end of year 1

Other Areas Covered (Just a Taste)

- Definition of a lease
- Discount rate (nonpublic can use risk free rate)
- Variable lease payments
- Modifications
- Sub leases
- Sale and leasebacks
- Residual value guarantees
And There’s Plenty More

- Initial direct costs (incremental costs only)
- Separating lease and non-lease components
- No more leverage lease accounting
- Lots of disclosures (no relief for nonpublic companies) including by Type A and Type B
- The cash flow statement:
  - Type A - Financing and Operating sections
  - Type B - Operating section
  [Type A = higher cash flow from operations]

Transition

- A modified retrospective approach (retrospective prohibited) for leases existing at (or entered into after) beginning of earliest comparative period presented
- Old capital lease (Type A) - use carrying amount
- Old operating lease (Type B) - record present value of remaining minimum lease payments plus residual value guarantee expected to be paid
- Lost of disclosures about transition
- Effective date - to be determined?
Transition - A Taste: Lessees

- Adopt 1/1/18 and present restated 2016 & 2017
  - 1/1/16 - prior capital leases still in effect - use previously recorded amounts
  - 1/1/16 - prior operating leases - put asset and liability on balance sheet and use Type B
- Optional relief provisions include
  - Do not reassess lease classifications (e.g., 74% still an operating lease)
  - Permit hindsight (e.g., lease renewals)

What Will Happen Now?

- FASB and IASB “sort of” converged
- FASB plans to issue the final lease standard in 2015
  - How should you get ready?
    - Lessees will record a big liability!
    - What about loan covenants? New systems?
  - Will there be a technical resource group for leases (e.g., A vs B type leases)?
  - Will users be better off if most leases have to go on the balance sheet?
Financial Instruments - Needs Fixing!

FASB previously issued two proposals:
- Credit losses - do we need a new model?
- Recognition and measurement - fair value or historical cost or both?

And now? New standards are coming very soon!

And what about derivatives? - Some day!

Goal? - Simplify and improve!

What about convergence? - Nope!

How to Recognize Impairment

- Problem for loans and securities - too little, too late
  A big change is coming!

- The new idea (from both FASB and IASB) - The incurred loss “probable” approach (FAS 5 - 1975) would be gone!

- The goal is to recognize “Expected Losses” but FASB and IASB approaches are different (so much for convergence)
Current Expected Credit Loss Model
“CECL”

- The new FASB approach would apply to all financial assets (not just held by financial institutions) that are measured at *amortized cost*.

- It would be applicable to financial assets such as loans and commitments, debt securities (held to maturity), trade receivables, lease receivables.

- Impact for amortized cost financial assets - recognize losses sooner!

Expected Losses

- Incurred loss model - gone!

- Allowance represents the current estimate of contractual cash flows not expected to be collected over asset’s expected life (Reflect risk of loss even if it is remote! Could you have a loss on Day 1?)

- But how do you estimate what the expected lifetime losses will be?
FASB Guidance

- Use not only historical experience and assessment of current conditions but also *reasonable and supportable forecasts that affect the expected collectability of the asset’s remaining contractual cash flows*

- There will be additional guidance on what to do for the period after this “*reasonable and supportable*” period ends e.g., there isn’t any for last 5 years of a long-term loan

Practicable? Auditable?

Other Changes

- Available for sale debt securities carried at fair value thru OCI
  - Use the current other than temporary impairment model (not the CECL model), except:
    - Use allowance approach that could be reversed
    - Don’t consider subsequent events or length of time fair value has been under cost

- New guidance on purchased credit impaired assets

- Lots of new disclosures about receivables and impairment (e.g., by “vintage” year)
Effective Date and Transition

- Effective date - open
- Transition - by cumulative effect adjustment as of the beginning of the year adopted
- Details are complex and disclosures will be required of the impact
- Final expected to be issued later this year
- What about implementation issues?

Implementation Issues

- Obtaining historical lifetime credit loss data
- Developing reasonable, supportable forecasts about the future
- Adjusting historical data to reflect forecasted information
- New disclosures - operational?
- PREPARATION SUGGESTIONS?
- And what did the IASB do about impairment?
IASB’s Three Buckets Model - a Taste!

**Bucket #1** - Initially record only losses expected to occur in next year. If credit quality deteriorates move down to #2 or #3.

For **Bucket #2 (groups) or #3 (individual)** - Now record losses expected over the entire life (e.g., 20 years) of the loan not just one year.

This has already been adopted in 2014 (in IFRS 9)

FASB concluded this bucket approach would just not be practical to implement - thus the world has two different expected loss models!

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Classification and Measurement

- FASB dropped their plans previously proposed to make major changes (e.g., more fair value)

  *These ideas received little support*

- Instead targeted amendments for modest improvements for financial instruments:
  - Equity investments
  - Fair value of company’s own debt under the fair value option
  - Dropping certain fair value disclosures for non-public companies
The “Improvements” - Equity Investments

Today
Available for Sale category - carry at FV with changes in value through OCI (unless impaired)

New Approach
Equities still at FV, BUT changes in value will be recorded directly in income and a one step impairment model - more likely than not (there will also be a practicability exception)

This will NOT change the use of the “equity method” of accounting

FV Option - Company’s Own Debt

Today
If the fair value option is elected all changes in value are recorded in income

Odd Result
If Company’s own credit rating goes way down (bad), the FV of its debt goes down, and this gives rise to income!

New Approach
The Company’s debt will still be recorded at FV BUT the portion of the change in value due to changes in the Company’s own credit rating will be recorded in other comprehensive income (an improvement!)
Disclosure

Today
Companies using historical cost for financial instruments today, have to disclose fair value parenthetically on the balance sheet.

New Approach
Nonpublic companies would no longer have to make this FV disclosure at all.

Other new disclosures will be required.

What About Convergence?

IASB - They did their own thing and their financial instrument standards have already been issued.

For example, debt securities can be carried at cost only if the instrument simply calls for principal and interest payments.

More complex financial instruments (e.g., embedded derivatives) carry at fair value thru income.

No Convergence!
Effective Date and Transition

- Effective date - not yet decided

- Transition - by cumulative effect adjustment as of the beginning of the year adopted, thru retained earnings (not retrospective)

- Will early adoption be permitted - still open

Summary Views

- Will these projects improve financial reporting?

- Will adopting the new leases and financial instruments standards also be difficult - will the effective dates hold this time?

- Should companies start to get ready?

- Is there hope for further convergence?

- Q&A
Revenue Recognition

- FASB and IASB issued their new standard on how to recognize revenue!

- The new model’s goals - Remove inconsistencies, more robust, comparability, more useful, and simplify!

- The FASB and IASB have achieved convergence!
  - Implementation issues
  - When and how to adopt
  - How to get ready
The New Model - A Quick Reminder

Core Principle
Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

Follow those same five steps!

The Five Steps

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

Seems easy but what about implementation issues?
Example - A Burglar Alarm System

- The contract (step 1) - To install a burglar alarm system and do monitoring for five years
- The performance obligations (step 2) - Installation and monitoring
- The price (step 3) - Customer pays $1,800 up front
- Allocate revenue to each performance obligation (step 4) based on the relative stand alone selling price of each performance obligation - assume it is $1,000 for each, thus $900 for installation (50%) and $900 for monitoring
- Recognize revenue (the Answer) (step 5) - $900 for system (recognize up front), $900 for monitoring (recognize over 5 years)

Approach to Implementation Issues

FASB & IASB formed Transition Resource Group (TRG)

- Consists of preparers, auditors and users - addressing many issues - TRG provides input to Boards and then Boards decide what to do about them. But FASB and IASB solutions may differ!
- The TRG does not issue guidance (i.e., it is not the same as EITF)
- TRG meets periodically in open meetings and over 50 issues have been discussed already!
1. Identify the Contract

- Contract creates enforceable rights and obligations (as a matter of law) and parties are committed - it is probable that entity will collect

- Implementation issues:
  - Collectability - more FASB guidance is coming!
  - What about: Licenses? Modifications and transition?

Licenses of Intellectual Property (IP)

- What is the promise to customer in granting a license?

- What is entity expected to do?

- Issues - recognize up front or over time?

- FASB will issue amendment (IASB will do a bit less)

- “Functional or Symbolic”
  Ex. License of Brooklyn Dodgers name?
Contract Modifications

Approved changes in scope and/or price of contract (e.g., customer change order): Determine if modification creates a new contract.

Implementation issue - What if a contract is modified during the transition period? Must all prior modifications be evaluated?

The FASB is proposing practical expedients for adopting - otherwise could be onerous.

2. Identify Performance Obligations

A promise to transfer goods or services to a customer

If there is more than one good or service, account for each separately if “distinct”

Implementation issues:
- Shipping and handling - fulfillment activity (expense)?
- Should you look for new performance obligations?
- What does distinct mean?

More examples will be added which should help
New Performance Obligations

- Are you expected to seek new performance obligations because of the new standard?
- Is free shipping a performance obligation?
- What about inconsequential or perfunctory obligations (a new car, free oil changes - are these two performance obligations)?
- FASB view - can disregard promises that are deemed to be immaterial to contract (IASB - no new guidance)

Distinct?

FASB plans to issue an amendment to clarify when a promised good or service is separately identifiable from other promises (i.e., it is distinct)

This decision impacts the revenue recognition pattern:

- For example, do multiple promises work together to deliver a combined item?
- Are there other “distinct” issues?
3. Determine the Price

How much the entity expects to be entitled to

Issues
- Variable consideration (e.g., royalties, rebates)?
- Collectability - If not probable, when should you recognize revenue? Portfolio issues?
- Non cash consideration (FV, but which date?)
- Significant financing component (discounting)
- Principle vs agent - gross vs net
- What about sales taxes? - gross or net?

4. Allocate the Transaction Price

Amount expected for each separate performance obligation - but how do you do the allocation?

Based on relative stand-alone selling price and, if not observable, estimate it!

*Is allocation likely to cause practice issues?*

*Will it be hard to estimate selling price?*
5. Recognize Revenue When (or as) Performance Obligations are Satisfied

Overall
Entity transfers the promised goods or service to the customer

When?
Customer obtains control either (i) over time or (ii) a point in time (e.g., customer has unconditional obligation to pay, legal title, physical possession, and risks and rewards)

Are there implementation issues in distinguishing over time vs. a point in time or when customer actually obtains control?

Other Issues - Construction Contracts

- Select an appropriate measure of progress over time towards completion using output or input measure
- Cost-to-cost may still be used as a measure of progress for recognizing revenue
- All project costs will no longer be deferred and recognized in the same manner as revenue
- Implementation issues? What about the completed contract method?
Capitalizing Incremental Costs

- When do you have to accrue a liability (e.g., commission on a renewal)?
- What costs are appropriate to capitalize?
- What about amortization related to a multiple element contract?
- What about recoverability?
- Will there be new guidance?

Disclosure After Adoption

**Objective**
Enable users to understand the:
- Nature, Amount, Timing and Uncertainty of revenues and cash flows from a contract with a customer

Provide lots of qualitative (e.g., judgments) and quantitative (e.g., disaggregation of revenue)

More for public than for nonpublic companies

Interims - disclose a lot but not as much as for year ends

Any implementation concerns (too much, systems issues to get data to disclose)?
Effective Date (using a calendar y/e)

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<th>Issued</th>
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<td>1/1/17</td>
<td>1/1/18</td>
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<tr>
<td>Early application - is it permitted? (but early is OK for IASB)</td>
<td>No</td>
<td>Yes - to 1/1/17 (not earlier)</td>
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Should FASB Delay Effective Date?

- **YES!** 2017 is too soon?
  - 1000’s of companies are affected
  - So many implementation issues are open
  - Costly - software, changing contracts
  - Transition difficulties

- **No!** Just do it & users want it
  - Delay is costly too (just put it off)
  - Many companies will be ready

FASB issued a one year delay proposal
Transition (assume effective date is delayed)

Retrospective for all years presented (achieving full comparability)
- but what about 5 year summary and SEC views?

OR  Elect the following alternative:

  Apply new standard as of initial application (e.g., 1/1/18) just to contracts that are not complete on that date

  Recognize cumulative effect as an adjustment to opening balance of retained earnings (e.g., on 1/1/18) and do not restate earlier years

  Provide additional disclosures

Disclosures Pre-Adoption

- Public companies are expected to disclose something before effective date!

- For example, how will the new standard impact their business, transition choice if company made it yet.

- Where should the disclosures be (footnote, outside the financials)?

- What is practice and what do users want?
What Should Companies (and Auditors) Be Doing Now?

Lot’s of reading to do - the standard itself, work of the TRG, lot’s of other guidance out there (e.g., auditing firms, AICPA)

Is waiting to get started a viable alternative?

New systems preparation?

Should contracts be modified?

Communications to users?

Q&A
May 29, 2015

Mr. James Schnurr  James R. Doty, Esq.
Chief Accountant  Chairman
Office of the Chief Accountant  Public Company Accounting
United States Securities  Oversight Board
and Exchange Commission  1666 K Street, NW
100 F Street, N.E.  Washington, DC 20006-2803
Washington, DC 20549

Dear Mr. Schnurr and Chairman Doty:

The U.S. Chamber of Commerce (“Chamber”)¹ created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The CCMC has a Financial Reporting Working Group (“FRWG”) that consists of representatives from other trade associations and a large number of companies of all sizes and a broad set of industries. The FRWG considers matters of common and general interest related to financial reporting and reporting on the effectiveness of internal control over financial reporting (“ICFR”) under Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”).

Accordingly, we respectfully request a meeting of stakeholders to jumpstart a dialogue between the business community, Public Company Accounting Oversight Board (“PCAOB”) and the Securities and Exchange Commission (“SEC” or “Commission”) in order to address issues impacting internal controls and audits that may erode judgment and impair capital formation.

¹ The Chamber is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are users, preparers, and auditors of financial information.
First, thank you both for meeting with the FRWG this past February to discuss issues regarding internal controls and external audits. 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. High standards and superior performance systems are essential for management, regulators and the audit profession to execute their responsibilities and for financial reporting to meet its intended purpose. However, 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.

We believe that this is the result of a lack of a dialogue between the business community and the PCAOB. Accordingly, we would respectfully request a meeting of stakeholders, the PCAOB and SEC to discuss these issues, explore ways to address them, and create such a dialogue on a continuous basis in order to promote effective controls and an appropriate exercise of judgment to enhance investor protection, capital formation, and competition.

In our view, such a meeting should focus on three areas: management review controls, a “checklist” or “one-size-fits-all” approach, and materiality. To stimulate this discussion, this letter, based on companies’ experiences, provides a context for the current environment and gives an overview of concerns in each of these three areas.

1. **Background**

Since 2002, the business community, the SEC, and the PCAOB have implemented provisions of SOX to improve financial reporting by creating a system for assessing the effectiveness of ICFR under Section 404. In addition, the PCAOB has implemented a robust inspection program for public oversight of the firms and individuals providing external audits for public companies—both integrated audits of the financial statements and ICFR, as well as audits of the financial statements only.
As audited financial statements are a crucial device to communicate with investors and raise capital, companies are strong supporters of internal controls. However, this road has had its ups and downs. Initially, the costs of implementing Section 404 were expensive and burdensome for companies generally. These costs and burdens were also regressive as they disproportionately increased inverse to the size of a business. Nonetheless, over the course of time and with efforts by the SEC and the PCAOB, particularly in 2006 and 2007, costs and burdens stabilized and improvements to financial reporting had a positive impact. For example, non-reliance financial restatements were at a high of 977 in 2005, and steadily declined to 255 in 2012.²

a. Rationalizing the Implementation of Section 404

The efforts by the SEC and PCAOB nearly a decade ago included the issuance of interpretive guidance for management reports on ICFR (“management guidance”) and replacing PCAOB Auditing Standard (“AS”) 2 with AS 5 for audits of ICFR integrated with financial statement audits.³ Under the SEC’s 404 implementation rules, management discloses its assessment on whether the company’s ICFR is effective at fiscal year-end. Management needs to have a reasonable basis for its ICFR disclosures. The SEC’s interpretive guidance is intended to help management do so.

The purpose of issuing management guidance and AS 5 was to rationalize the planning and conduct of the ICFR evaluation process and audits of ICFR—for all companies, regardless of size. The SEC and PCAOB were committed to allowing management and auditors to get “out of the weeds” and focus on what matters most.

The SEC and PCAOB recognized that assessing and attesting to the effectiveness of ICFR is all about risk and materiality. For example, the SEC’s management guidance is intended to allow companies to focus their efforts on those areas that management identifies as posing the greatest risks of material misstatements in the financial statements

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not being prevented or detected on a timely basis. The SEC appreciated that this is what investors care about and what is important for achieving reliable financial reporting.

The SEC’s guidance is supposed to allow management to exercise significant and appropriate judgment in designing and conducting an evaluation that is tailored to the company’s individual facts and circumstances. It is worth noting that under SEC guidance prior to SOX, management is responsible for maintaining a system of internal control that provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP). The “reasonable assurance” referred to in the SEC’s rules implementing Section 404 relates to similar language in the Foreign Corrupt Practices Act of 1977 (“FCPA”). Exchange Act Section 13(b) (7) defines “reasonable assurance” and “reasonable detail” as “such detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.” The Commission has long held that:

“[R]easonableness” is not an “absolute standard of exactitude for corporate records.” In addition, the Commission recognizes that while “reasonableness” is an objective standard, there is a range of judgments that an issuer might make as to what is “reasonable” in implementing Section 404 and the Commission’s rules. Thus, the terms “reasonable,” “reasonably,” and “reasonableness” in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.

The SEC also recognizes that reliable financial statements come from control systems that provide reasonable assurance. Control frameworks such as COSO 1992 and COSO 2013 explain what is required of a system to achieve reasonable assurance, unlike the SEC’s management guidance and the PCAOB’s auditing standards, including AS 5, which do not.

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6 See SEC management guidance (p. 3). The SEC’s management guidance also discusses that the conference committee report on the 1988 amendments to the FCPA note that the standard “does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance” (p. 3).
Therefore, spending inordinate amounts on audits does not promote investor protection or provide the basis for an effective and sustainable system of controls. ICFR audits can only help assure that management’s disclosures are materially correct. The SEC staff worked closely with the PCAOB on coordinating their respective sets of guidance to ensure that there was not an expectation that controls needed to be designed and tested to fit the audit—rather the audit should be planned and conducted to fit the controls.

To improve the implementation of Section 404, the SEC’s management guidance and AS 5 are aligned. Both sets of guidance are principles-based and intended to provide for the exercise of judgment by management and auditors under a top-down, risk-based approach to management assessments and auditor attestation of ICFR, respectively. In describing this approach, the guidance includes the role of entity-level controls in assessing financial reporting risks and the adequacy of controls.

Along with providing for effective ICFR assessments and attestation, the respective sets of guidance for management and auditors are intended to promote efficiency. For example, the SEC’s interpretive guidance states:

The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR. Rather, management can focus its evaluation process and the documentation supporting the assessment on those controls that it determines adequately addresses the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.7

To summarize, “reasonable assurance” is the foundation of SEC requirements that registrants maintain adequate books and records and systems of internal controls. Reasonable assurance is also the foundation of the COSO 1992 and 2013 frameworks.

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7 See the SEC’s interpretive guidance for management, pp. 4-5.
and the SEC’s interpretive guidance for management on evaluating the effectiveness of ICFR.  

Companies are passionate about supporting the goal of high quality financial reporting and recognize the contributions of effective systems of ICFR to achieving this goal. In this regard, companies appreciate the role of effective audits and the PCAOB inspection process. In addition, companies do not decide what auditors need to do for their audits.

However, balance is essential and it is reasonable to expect that companies understand why certain audit activities take place. It is problematic to expect companies to support apparent excessive compliance activities that are not understood and where the costs clearly exceed the benefits. Additionally concerning is the apparent retrenchment on the rationalization of the implementation of SOX Section 404. In the current environment, from a company perspective, principles-based guidance, such as the SEC’s guidance for management and COSO, has not been able to withstand the authoritative weight of new interpretations of AS 5 for auditors from PCAOB inspections and the goal of both audit firms and individual auditors to reduce the risk of inspection findings.

We appreciate the opportunity to discuss how to obtain the right balance in the current environment based on the foundational concept of reasonable assurance, along with materiality and the principles of SEC management guidance and AS 5 for top-down, risk-based approaches to ICFR assessment and attestation.

2. Specific Concerns

This section summarizes some of the concerns identified by the business community that have arisen in the current environment in three areas: management review controls, a “checklist” or “one-size-fits-all” approach, and materiality. To better understand the nature of the concerns and explore feasible options for addressing them, a sample of experiences of companies are presented in bullet-point format and described

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8 PCAOB auditing standards require that the auditor must plan and perform the ICFR audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management’s assessment. In an audit context, reasonable assurance is defined as a high, but not absolute, level of assurance.
in their own words.” While the experiences reflect some variability, there is nonetheless consistency across them on the overarching need to obtain the right balance in the current environment.

a. Management Review Controls

As discussed in the background section of this letter, a focus on entity-level controls is an important element of the top-down risk-based approach emphasized in the SEC’s management guidance and AS 5. Unfortunately, the ability of companies (and auditors) to rely on entity-level controls, including management review controls, has become a challenge in the current environment. This is particularly problematic because management review controls are critically important to companies for addressing the risks of material misstatements in financial statement amounts and disclosures. Thus, what is actually most important to companies is now being deemphasized. Several factors are contributing to this situation. The following are illustrative of some of the experiences and concerns of companies regarding entity-level controls, particularly management review controls:

- Expectations around the evaluation of control design have moved well beyond the guidance in AS 5 and are not in line with risk associated with the control. The overall direction appears to be deemphasizing the risk-based approach and appropriate reliance on entity-level controls that were introduced as part of AS 5. Indeed, it appears that the audit industry has taken a step back to auditing exhaustively the process level controls and has made the bar so high for reliance on entity level controls that they are being scoped out of the framework. It appears that practice is moving gradually back to AS 2 as a result of the PCAOB inspection process.

- Requirements for documentation and levels of precision around management review controls are increasing without regard to the underlying control environment. Auditors are pushing for all review controls to have specified precision (quantitative thresholds) and no qualitative measures can be relied upon because they are not evidenced as clearly as quantitative measures. This takes any judgment or knowledge out of the process and causes companies to focus time and effort documenting their review controls to pass the audit tests rather than focusing effort on
the type of review that would most benefit the control environment. Further, it appears that all testing of management review controls (e.g., analytical reviews) must be the same (and fully documented) regardless of risk and the auditor’s familiarity and historical experience with the process.

- Most of the work related to gathering additional evidence of review controls has been non-value added. As a result, companies are adding more process level controls around transaction processing since these are easier to evidence and test by auditors. However, review controls are what companies rely upon. And, a major part of a system of internal control is to have experienced, qualified finance professionals that have the skills to review and question transactions and results.

- Auditors appear to have a bias to exclude review controls where possible and/or encourage the addition of control activities that eliminate business judgment. Auditor control testing methodology and acceptable audit evidence does not appear to adjust for internal control components beyond control activities. Even though AS 5 states that the auditor can employ a mix of approaches, the audit firm’s “review control” guidance states that the approach and evidence should be the same for all types of controls, irrespective of control objective.

- Significant growth in key controls has occurred specific to control activities in contrast to other COSO components and driven by increased pressure from auditors to have controls operating at the lowest level of precision rather than appreciating the assurance received from the broader integrated framework. Over-reliance by the auditor on control activities is also counter-productive to the value of implementing COSO 2013.

- Adding lower level or other key controls and testing by auditors has several other implications for companies. For example, companies end up supporting the increased work of the auditors related to additional testing and documentation requirements for these controls (e.g., walkthroughs, flowcharts, increased sample sizes and related furnishing of documents, discussions, etc.). This additional work requested of the company is significant.
• The auditors required “the review of offer letter data entry” as a key control rather than relying on seven existing key controls operating at a range of precision (e.g., journal entry review, cost center/salary reconciliations, multiple meetings/department review controls/group/business unit headcount and spending analysis, country level flux analysis etc.) In addition, the company experienced an increase in auditor designing controls and/or architecting control language to facilitate a one-for-one mapping of risk to control.

• 20% of the company key controls classified as monitors, information and communication, and risk assessment were not acknowledged or evaluated as part of the overall design assessment by the auditors. Yet, these control components provided valuable assurance over critical financial statement risks as part of the overall control framework.

i. Documentation Issues Related to Management Review Controls

• The PCAOB inspection process requires auditors to document the “precision” of every significant judgment, decision, or review procedure performed by the company’s personnel performing or reviewing the controls over an account. In reality, it is a very time consuming and potentially impossible task to document every complex judgment made by experienced personnel when performing or reviewing controls. What is most important is the competency of the personnel making these judgments. Moreover, without this documentation, even if control and substantive audit results show an account has no errors, the auditor is not allowed to conclude that the controls within the account operated, or the judgment of the personnel performing the controls was competent. It does not appear that auditors are allowed to exercise their own professional judgment, as PCAOB inspectors conclude that if something is not documented, it did not occur. As a result, companies and auditors spend an extensive amount of time attempting to document every judgment and decision made in complex accounts to avoid having auditors receive PCAOB inspection comments. In turn, auditors end up focusing on documentation rather than substance.
• Auditors are aggressively challenging the effectiveness of management review controls through documentation requirements. This has become especially difficult and time consuming in an electronic (paperless) environment. In turn, companies have to meet these extensive documentation requirements for reliance on controls classified as management review and for reliance on reports produced by computer applications (known as "electronic audit evidence” (EAE). An added consideration is that companies have had to spend resources to train personnel in order to implement these new documentation requirements.

• Documentation requirements to prove robust reviews have taken place are exceptionally time consuming. Sign-off or approval is no longer sufficient—comments about the details or tick marks evidencing a “number” or “fact” have been considered as being used to conclude whether a review has been performed. In an electronic/paperless environment this is even more time consuming, and the company reverted back to documentation style from the early years of SOX.

• In 2013, the auditors established a prescribed 3-page framework document for how review-based controls need to be defined and evidenced by the company. This resulted in an unplanned impact of approximately 500 hours across the company to document a prescriptive set of criteria for how reviews occur, and to remove professional experience and judgment expected in a review. This also illustrates the emphasis being placed on designing checklist controls and formulaic driven judgment.

• The company had not entered into a new inventory supply agreement since 2010. The auditors requested that the company go back and find emails or other support to demonstrate the contract was reviewed at a proper level of precision by the proper individuals of the company. This is an example where the company pushed back—how does this demonstrate that controls are designed and operating effectively in fiscal year 2015? Nonetheless, these are the kind of requests companies are receiving from auditors.
The company has certain liability accounts that require significant judgment. As part of our SOX control process, management meets on a quarterly basis to discuss the assumptions and review the appropriateness of the liability balances. Although we previously did not document meeting minutes, this meeting is evidenced by a comprehensive presentation document that is discussed during the meeting. The auditors have asked that we now document the meeting minutes or if that was not feasible, they suggested the auditors could attend the meeting as evidence of what was being discussed. We do not believe that documenting meeting minutes would be value-added as the meeting itself accomplishes the control objective, which is ensuring that the liability balances are appropriately stated. We also would prefer not to include the auditor in the meeting as we want to ensure a safe environment where everyone feels comfortable speaking openly. Documentation of minutes at the granular level that is now required is non-value added.

ii. Training of Company Personnel to Adequately Perform and Document Management Review Procedures

In order to prepare the company’s accounting staff to adequately document management review (and EAE) procedures in accordance with the external auditor’s new documentation requirements, the company had to conduct an elaborate training program. This training involved compiling a 25-page set of instructions with examples of what the auditors expected for management review (and EAE) documentation; distributing these instructions to approximately 50 accountants throughout the company; and providing webinar and in-person training sessions to explain expectations and answer questions. This training was conducted such that two detailed matrices for each of the accounting processes could be prepared (one for management review controls and the other for EAE used in those controls). These comprehensive matrices (consisting of 19 columns of information per control with 230 rows of data for the management review matrices and 17 columns of information with 360 rows of data for the EAE matrices) were prepared to supplement the company’s process narratives and provide the required documentation for these items to the external auditors. These matrices now need to be updated each year.
Management estimates that the manager of accounting internal controls spent 600 hours on these tasks; in addition, it took about 1,500 hours for the matrices to be completed by the accountants. None of these changes improved the underlying quality of the review.

b. “Checklist” or “One-Size-Fits All” Approach

i. For ICFR Documentation

- Process narratives (memoranda) are no longer sufficient. Auditors are requiring flow charts to supplement process narratives for all significant areas. In turn, process narratives are required to include a level of detail more akin to the documentation requirements circa AS 2 (10 years ago). For example, auditors are requesting supporting documentation for every aspect outlined in a process narrative regardless of whether it is key or not.

- Citing PCAOB inspection reports, the auditor requires a fully documented re-articulation of the process, a test of “one for all” processes and controls regardless of risk, and documentary evidence beyond documenting what is required for the test of control.

- The auditors utilize specific templates for their walkthrough documentation to ensure that all PCAOB inspection points of focus are addressed. These templates are time consuming to complete and do not contribute to the overall value of the process walkthrough in a significant manner. In addition, the company was required to use these walkthrough templates for the walkthroughs it performed on the external auditor’s behalf.

ii. Regardless of Risk

- Inspection results are driving auditors to perform a similar scope of procedures for lower risk accounts (that have little judgment and complexity) as for higher risk accounts (that involve significant judgment and complexity). Accounts are either “in-scope” or “out of scope.” If in-scope, all accounts appear to be tested with the same level of procedures in order to avoid PCAOB inspection findings.
The auditors are required to treat multiple locations (e.g., regions of the country) as separate populations. This requires separate sample selections for each location, even if the accounting policies, processes, and systems are the same across all locations.

Auditors have been required to significantly reduce their reliance on work performed by internal auditors. Despite the fact that both internal and external auditors typically report directly to the audit committee, external auditors are now required to re-perform work done by internal audit. The conclusion not to rely on the work of internal audit is not based on the merits of the facts and circumstances of the particular company but rather is a rule that applies across the board to all companies.\(^9\)

PCAOB inspection results appear to focus on “hot topic” areas without acknowledging that an account can be high risk for one company, but low risk for another. For example, even revenue in companies with non-complex, automated revenue processes can have a much lower risk profile. However, as revenue is viewed as a “hot topic” in PCAOB inspections, auditors are not allowed to apply professional judgment on the extent of procedures performed. Thus, extensive time is spent on an account with inherently low risk by auditors and by the company personnel providing information to the auditors. Other “hot topic” areas include related party transactions, defined benefit pension plans, investment valuations, inventory write-downs, fixed assets, business combinations, intangibles, and multi-location audits.

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\(^9\) We note that AS 5.19 states: “The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.”\(^10\) In promulgating AS 18, the PCAOB changed the language in AU 333.06.1 on Management Representations from matters including: “Information concerning related-party transactions and amounts receivable from or payable to related parties” to: “Information concerning related party transactions and amounts received from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm’s-length-transaction.”
iii. Use of Checklists and Templates

- PCAOB inspection results frequently focus on minute defects, departures from audit methodology, or lack of persuasive documented evidence within an account without regard to whether or not the account is a high risk account for the company. As a result, audit firms have developed extensive forms to facilitate quality assurance. Completion of these forms has increased audit hours for many accounts by more than 100%. However, the focus of these hours is on documentation and not substance or risk.

- The audit team spends a significant amount of time completing templates or checklists based on the firm’s documentation standards. This distracts the team from having time to fully understand the business and determine if the disclosures or controls are material/key or a risk area to our company. Standard templates and procedures appear to have replaced auditor judgment. A key area is around significant estimates (fair value estimates) and disclosure requirements. This leads to having to respond to multiple inquiries from various audit members on the same questions. The extensive documentation also detracts from the audit staff learning accounting and auditing skills. There is so much focus on documentation and testing of controls that the staff is not generally getting exposure to how transactions are accounted for.

iv. Related Party Transactions

- PCAOB AS 18 is effective for audits of fiscal years beginning on or after December 15, 2014. It covers related party transactions, significant unusual transactions, and amendments to other auditing standards, including changes to management’s representations to the auditor on a quarterly and annual basis.\(^\text{10}\) In implementing AS 18, auditors are now asking companies to provide them with a list of the names of all related parties (even if the

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company has no related party transactions) and also that there are no side agreements or other arrangements (oral or written) undisclosed to the auditors. Given the GAAP definition of related parties, companies are facing challenges in putting together a complete list of related parties and side agreements. For example, companies are being told to identify all entities in which a member of management controls, or has significant influence over, or serves in a leadership role. Board members are also scoped into this listing and companies are facing challenges in being able to identify all family members who might control or influence.

Furthermore, auditors are now asking management to represent: “We have made and caused the company to make available to you the names of all related parties and all relationships and transactions with related parties;” that “transactions with related parties…and information concerning these transactions and amounts have been made available to you,” and “there have been no side agreements or other arrangements (oral or written) undisclosed to you.” This is a big change from the previous language used by the auditors in management representation letters in which auditors asked whether: “Significant transactions with related parties…have been properly recorded and disclosed in the consolidated financial statements.” The new language loses sight of the fact that GAAP requires disclosures of material related party transactions (other than compensation arrangements, expense allowances, other similar items in the ordinary course of business, and transactions eliminated in the preparation of consolidated or combined financial statements (ASC 850-10-50-1)—with an objective of disclosing related party transactions that would make a difference in users’ decision-making (ASC 850-10-10). It also seems inconsistent with the actual language in PCAOB AU 333 on Management Representations (see footnote 9).

These new requirements assume a level of precision in collection procedures (e.g., capturing all related parties and side agreements) that does

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11 We appreciate that the SEC requirements for disclosing (in proxy statements and other filings) transactions with the company in which any related person had or will have a direct or indirect material interest has a relatively low threshold. However, the respective GAAP and SEC definitions of related parties differ and this represents an area where GAAP and SEC corporate disclosures may not link up.
not exist today in preparers’ systems and would require significant incremental effort to achieve. Company control procedures that are in place to meet current related party reporting and disclosure obligations are not at zero thresholds. It is also unclear how companies can address a 100% certainty of no side agreements or other arrangements, no matter how inconsequential. Further, it is unclear what all of the terms mean (e.g., what is covered under “other arrangements”—what its scope should be).

It is almost impossible to make these requirements operational and at the same time retain reasonable levels of procedures. While the auditing standard requires the auditor’s work to focus on related party transactions that pose significant risk, the preparer is being required to have procedures to identify related party transactions and side agreements even if they are inconsequential, which appears wholly inconsistent with GAAP (ASC 850). As noted, GAAP requires disclosures of material related party transactions with the objective of providing information that would make a difference in users’ decision-making. Bear in mind that related party transactions often occur in the normal course of business, including: sales, purchases, and transfers of real and personal property, services received or furnished, leases of property and equipment, lending and other financial transactions, intra-entity billings based on allocations of common costs, and the list goes on. This level of granularity (not based on GAAP, risk, or materiality) makes it nearly impossible to provide auditors with what they require to meet the interpretation of the new auditing standard. For this quarter, some companies adjusted their management representations for related parties and side agreements or other arrangements to focus disclosure to the auditors of all material items. Companies continue to evaluate their current procedures and what they can do to support the auditors need to comply with AS 18, and at the same time retain reasonable control procedures.

v. Non-Integrated Inspection Process

- Companies and management are strong supporters of robust internal controls over business activities and financial reporting. In fact, the main focus of effective business management, top down, starts with risk
assessment followed by establishing effective internal controls over both business practices and financial reporting. Further, internal audit departments plan their activities starting with their assessment of risk and their evaluation of internal controls. External auditors likewise determine their financial statement audit scope and plan by integrating risk assessment and evaluation of internal controls over financial reporting. And, of course, the financial statement audit is integrated with the audit of ICFR for accelerated filers.

However, there seems to be a disconnect between the integrated approach and requirements that business managers, internal auditors, and external auditors use and what some companies understand is the approach used in the PCAOB inspection process. Some companies understand that the inspections of ICFR and financial statement audits are treated by the PCAOB as two separate inspections in that they are staffed with two different and independent inspection teams. It is difficult to understand how two pieces of an integrated audit can be effectively inspected without an integrated understanding of the inter-relationship of risk, controls, materiality, and resulting financial reports. It is therefore not surprising that ICFR inspection findings have increased. The assessment of ICFR alone cannot be done in a vacuum without the complete integrated understanding of a business, its material risks, its internal controls, and its financial statements.

C. Materiality

i. Related to Reclassifications and Disclosures

- Auditors are required to accumulate information on items that are clearly immaterial at the consolidated level and, in many cases, report this information to audit committees. The PCAOB concluded about three years ago that there was a single threshold for evaluating errors in the balance sheet and income statement. As a result, auditors must accumulate information for balance sheet reclassifications at a threshold as is applied to a net earnings impact and present these to the audit committee in the “Summary of Unadjusted Audit Differences.” This seems wholly
inconsistent with views expressed by the SEC on materiality and leads to non-value added work by auditors, management, and the audit committee. Similar practices do not appear to be followed in other (foreign) jurisdictions.

- In the past year, auditors have begun to extend the “single quantitative threshold” to disclosures. In addition, they have started insisting that if one disclosure item is material than all required disclosures must be presented, regardless of materiality. These disclosure changes have been attributed to the PCAOB inspection staff. These changes have the effect of making the disclosures more detailed without providing material information to investors and are placing additional burdens on audit committees by having to review longer reports and immaterial errors or immaterial information in disclosures. There is a fundamental conflict between these changes and work underway by the SEC and FASB on disclosure effectiveness.

- During the year-end audit process, the auditors identified an adjustment in the tax area for a balance sheet reclassification between line-items. The amount represented a meaningful adjustment when compared against the income statement, but the adjustment was less than 0.5% of total assets and less than 1% of current assets. The reclassification was clearly minimal to any investor that would be reviewing our balance sheet, and it is absurd to conclude that an investment decision would be in any way altered by a minor balance sheet reclassification compared to a large asset base, simply based on how the adjustment measures against operating results. The PCAOB has driven a faulty standard of comparing balance sheet (reclassification) materiality based on an income statement calculation. In addition to discussing this matter extensively with the audit firm, the company also was required to generate significant amounts of documentation on why this matter was not considered to be a material weakness or significant deficiency.
ii. Related to Entity-Level Controls

- Our auditors are now doing more with lower level affiliates that are immaterial individually, but could be material in the aggregate. The view of the PCAOB (the company understands) is that entity-level controls at a higher level cannot be relied upon for these lower material affiliates if the entity level testing is only done for the higher materiality affiliates. So now, the auditors are spending more time and effort testing affiliates that are truly immaterial.

Conclusion

Thank you again for your candor and willingness to engage on these issues. Our hope is to start a long-term dialogue to ensure that we have strong controls in place to provide investors with reliable decision useful information to facilitate an efficient capital formation process.

We hope that you find these illustrative examples helpful and we would like to take the next step and work with you to have a meeting of stakeholders to discuss these concerns and identify possible alternatives to address them.

Sincerely,

Tom Quaadman
Good morning. Thank you Christine [Davine] for the introduction. It is a pleasure to be with you, and I am honored to be addressing you today as the Chief Accountant. Having attended the annual AICPA National Conference on current SEC and PCAOB Developments on a number of prior occasions, I have always found the dialogue to be extremely beneficial, particularly as we reflect upon significant milestones during the past year and plan ahead for the challenges and opportunities that await us in the coming year.

As always, I must begin with a reminder that for me and for the SEC staff speaking at this conference, the views expressed are each speaker’s own and not necessarily those of the Commission, the individual Commissioners, or other colleagues on the Commission staff.

IFRS

Now I would like to spend a few minutes discussing a topic that I know is of interest to many of you – IFRS. In May of 2014, Chair White spoke to the Financial Accounting Foundation and highlighted that having the Commission focus on IFRS was, and would continue to be, a priority for her. Chair White noted that international regulatory and accounting constituents continue to want clarity on what action, if any, the Commission will take regarding the further incorporation of IFRS into the U.S. capital markets, and she was hopeful that the Commission would be able to provide that clarity sooner rather than later.

Since 2007, the Commission has allowed foreign private issuers to report under IFRS without reconciling to U.S. GAAP. These issuers are clearly a significant component of the U.S. capital markets, making up trillions of dollars in aggregate market capitalization. However, while the experience thus far with foreign private issuers has been positive in my view, I would like to emphasize that the regulatory considerations for foreign private issuers are different than for domestic registrants. Therefore, while historical knowledge gained related to the use of IFRS by foreign private issuers has proven to be useful, any recommendation with respect to our domestic registrants will need to be made independently of those made for foreign private issuers.

When I arrived at the Commission two months ago, Chair White asked me to take a hard look at where the staff had been on the issue and make a recommendation to her as to the path forward. Before discussing where the OCA staff is and where I hope to lead us in the near future, I would like to emphasize a couple of points. I strongly support the overarching goal of providing investors with
high quality decision-useful information to allow for informed investment decisions that facilitate capital formation. And, as the Commission envisioned in its statement in 2010, we continue to strive for high levels of comparability, as is practical, between financial information provided for domestic and international issuers. While these goals remain at the forefront, Chair White and I both recognize that any continued uncertainty around IFRS results in uneasiness for investors across the globe. Therefore, it is a priority of mine to bring a recommendation to the Commission in the near future with the hope of resolving, or at least lessening, this uncertainty.

In addition, while previous efforts by the staff provide me with a starting point, I do not have a pre-determined view of an approach, and I am open to continued dialogue surrounding the best ways to further these goals. That said, I think it’s important to reflect on what we’ve learned over the past several years, as I believe this frames the current thinking and any potential path forward.

I feel privileged to be coming into this complex area with an extensive base of staff work that provides us with a strong foundation as we continue this journey. I would like to acknowledge the work of my predecessor, Paul Beswick, who led the efforts to compile the IFRS work plan that was completed in 2012. This work plan was the result of a significant effort by our staff which produced an informative and insightful synopsis of potential paths forward and pertinent considerations on the role that IFRS might play in the domestic financial reporting environment.

During this journey, various constituents also have been asked for their views related to the desirability and feasibility of a full movement, optional or otherwise, to IFRS for domestic issuers. Therefore, most of the feedback we have received has been provided to us with a full movement 'end game' in mind. Based on what we have heard to date, it appears that U.S. constituents generally are not supportive of full adoption for a variety of reasons, including legal issues and general cost-benefit concerns, among others. Those concerns will certainly be considered in my analysis. US constituents have also raised similar issues with a broad-based option. These issues include legal impediments, practical challenges, and an impact on comparability that does not currently exist in the domestic reporting environment.

So where does that leave us? As we focus our efforts on any potential paths forward, we are looking for feedback regarding other alternatives that might or should be explored regarding any further incorporation of, or alignment with, IFRS for domestic issuers. With this mindset, the pros and cons of any alternatives must necessarily start with what interest exists for further IFRS incorporation and what impact it could have on our reporting system, and therefore how it would affect investor protection.

As one example, we understand that some domestic issuers may, now or in the near future, prepare IFRS-based financial information in addition to the U.S. GAAP based information that they use for purposes of SEC filings. However, regulatory constraints may dissuade some issuers from providing this information, as current SEC rules would consider IFRS-based information to be a "non-GAAP" financial measure for a domestic issuer. Should IFRS-based information continue to be considered "non-GAAP" financial measures subject to the requirements for such measures, or should it be thought of differently? Under this line of thinking, issuers that do not believe IFRS-based information would be beneficial to investors would not be forced to undertake what we understand to be, in some cases, significant implementation costs.

But that’s just one example. I am hopeful that my remarks today will serve as a starting point for the continuation of this journey with you over the next few months. Based on the progress of our collective efforts, I am hopeful to be in a position in the coming months to commence discussions with the Chair and the Commissioners about the different alternatives for potential further incorporation of IFRS and the related issues/concerns of each alternative with the objective of
reaching a recommendation on what, if any, further incorporation or use of IFRS by US registrants would be permitted or required. And, of course, any rulemaking proposal that the Commission decides to consider would be subject to the normal notice and comment process.

In the meantime, I would like to express my support and gratitude for the efforts of both the FASB and the IASB on the development of converged high quality accounting standards. The issuance of the revenue recognition standard in May of this year was a significant step in communicating to the capital markets that converged standards are possible. I commend the boards for this achievement and encourage them to continue to work towards converged standards, including on lease accounting, where we have the same basic model and it would seem a missed opportunity to not remain converged on such a broadly applicable topic. Whatever the ultimate result is with respect to IFRS in the U.S., the boards should continue to strive where practicable for aligned high-quality global standards.

Revenue recognition

Staying with the topic of the new revenue standard, while the issuance of the standard marked a significant milestone in the convergence efforts of the FASB and IASB, it is by no means the end of the journey. Successful implementation of the new standard will be critical to ensuring comparable, high quality financial reporting for investors.

Since the issuance of the standard, the Staff has been actively monitoring the collective implementation efforts through ongoing discussions with a variety of stakeholders and attendance at various meetings and conferences that address the new standard. As the new Chief Accountant, I want to assure you that the implementation of the standard in the United States in a timely and consistent manner will continue to be a priority for me and my Staff.

Broadly speaking, I might categorize implementation efforts into two buckets. First are the questions on how to apply the guidance to particular fact patterns, the “accounting” phase if you will. Second are the necessary process and systems changes necessary to produce information consistent with the accounting conclusions, the “process” phase. We have heard that many companies would understandably like to finalize their accounting assessment and to commence their process-related implementation efforts, especially if the company would like to apply a retrospective transition method. We recognize that in order to advance implementation in a timely and consistent manner, preparers will need answers to their accounting questions.

We understand from speaking to various parties that there are a variety of accounting questions that range from questions that may require additional action by the standard setters to questions that appear to be more educational and simply need clarification as to what the intentions of the boards were when drafting the standard. It is our understanding that a number of the concepts that exist in current revenue guidance were carried over into the new standard, although the wording in the new standard removes some of the specificity that currently exists in the Codification. In these cases, some preparers may be asking if the accounting has changed even though the boards did not intend, or expect, to change current practice. I would hope that many of these questions can be disposed of quickly, and the standard setters can focus on the more novel interpretive questions that are arising in applying certain of the principles introduced in the new standard.

As with all new standards, our focus, and I hope a focus of the FASB and IASB jointly, will be on consistent application of the new standard with a view towards promoting comparability. In my view, well defined principles should yield consistent results when applied to a similar set of facts and circumstances. If there is significant diversity in practice for similar transactions, then it raises the question as to whether the principles in the standard are adequately articulated; and disclosure is not a substitute for comparability. I am optimistic that the FASB and IASB will jointly address the
implementation questions as we continue to seek convergence. To assist in this effort, the Staff will consider what, if any, additional guidance is needed from the FASB or the Staff to ensure that the needs of U.S. investors are being met.

I want to clarify that the Staff respects reasoned judgments, but where significant diversity in practice exists, we seek to eliminate that diversity. Comparability is a hallmark of U.S. financial reporting, and I believe that it is in the best interests of all parties to identify and address potential diversity in practice on the front end of the implementation effort, as doing so should avoid significant costs of narrowing practice after adoption for preparers and avoids the lack of comparability for users.

To that end, the boards’ Transition Resource Group has identified and begun to address a number of these implementation issues. Certain of the issues raised could have a significant and widespread impact. For instance, we understand that unresolved questions regarding the identification of performance obligations and the accounting for licenses is placing some stress on being able to implement the standard by its current effective date. I believe it is critical for the FASB and IASB to address these and other unresolved questions, especially as they evaluate the effective date and assess whether additional time may be needed to address implementation matters.

Finally, it is imperative that investors understand how the guidance will impact a registrant’s financial statements, including the impacts that extend beyond reported revenue amounts. Throughout the implementation process, I encourage registrants to maintain open dialogue with their investors regarding anticipated changes and the potential impacts of adopting the new standard.

The role of the independent standard setter

I now want to emphasize how important an independent standard setting process that is focused on the needs of investors is to the capital markets. The quality of financial information is paramount to the confidence of investors and the formation of capital. While financial reporting may also be relevant to other users, I believe the development of U.S. GAAP must remain focused on the needs of investors.

The Commission has consistently looked to the private sector for leadership in establishing and improving U.S. GAAP. Since the 1970s, the FASB has been that private sector standard setter. Part of the reason a private sector standard setter has been so important is because the work they do is focused on the objective of setting accounting standards that provide neutral, decision-useful information, free from political or other pressures or objectives. I believe the Sarbanes-Oxley Act strengthened that independence, and I believe that this independence has resulted, and continues to result, in better accounting standards.

Independent accounting standard setting is critical to encouraging a financial reporting system that is robust and responsive to the needs of investors. But investors must have confidence in how those standards are set. Open due process, including thoughtfully considering the input and views of those who participate and play a role in our capital markets, is critical to the standard setter in fulfilling their mission of establishing and improving financial accounting and reporting standards. However, standard-setting that is focused on other objectives, or on the winners or losers that might result from the provision of neutral decision-useful information, would impair the confidence investors have.
As we reflect on the recent issuance of the revenue recognition standard and look forward to the issuance of several other major standards, the standard setting process will again be at the forefront of discussions among a variety of stakeholders. I would like to take this opportunity to reiterate my support for the independent standard-setting process. A credible and independent standard-setting process is in the interest of investors and is critical to the broader capital markets.

**PCAOB Standard Setting Activities**

While on the topic of standard-setting, I’d like to turn to standard-setting at the PCAOB. Since its formation, the PCAOB has maintained an aggressive standard setting agenda. Significant projects have been on the PCAOB’s agenda to update existing audit and quality control standards for several years.

Consistent with past remarks made by my predecessor, I believe that the most effective way to improve audit quality is to update the standards that directly address auditor performance incorporating both the knowledge the PCAOB has gained through inspections and the public information available on restatements and other relevant data. Over the last several years SEC Chairs, Commissioners, Chief Accountants, and my Deputy Chief Accountant for the Professional Practice Group, Brian Croteau, whom you will hear from shortly, have all publicly encouraged the PCAOB to accelerate the pace of standard setting. Notwithstanding these efforts, some of the most important projects to update auditing and quality control standards that are on the PCAOB’s agenda simply have been moving too slowly.

Considering the lack of progress on a number of projects, I have questioned what might be the root cause or causes with respect to the PCAOB standard setting process. Accordingly, Jim Doty and I have discussed the need to work together with the other PCAOB Board Members to take a fresh look at the PCAOB’s standard setting process with a focus on what improvements can be made to the timing of a project from inception to adoption of a standard or termination of a project. I am optimistic that working together the PCAOB can begin to reduce the significant standard setting backlog.

**Reconsideration of Audit Committee Disclosures**

The last topic I would like to address relates to audit committees. Audit committees play a critical role in providing oversight over, and serving as a check and balance on, a company’s financial reporting system. Earlier this year, Chair White asked the staff to examine the existing audit committee report to seek ways to make it more useful to investors. She observed that the audit committee reporting requirements have not changed significantly in a number of years and that it is time to take a look at whether improvements can be made.

From my perspective, the increasing desire by investors to hear more from audit committees is understandable given the important role that audit committees play. The Sarbanes-Oxley Act resulted in significant changes to the role and responsibilities of audit committees, yet, as Chair White observed, SEC disclosure requirements for audit committees have not changed since 1999. Some of the public comment letters received by the PCAOB on their projects related to audit transparency and the auditor’s reporting model have made general or specific suggestions for SEC consideration on how to improve existing audit committee disclosure requirements. We’re also cognizant that changes in the roles, responsibilities, and disclosures by audit committees have been afoot in other jurisdictions for some time.
Meanwhile, some audit committees have taken their own initiative to evaluate how to enhance their disclosures and have included disclosures that go beyond the requirements in our existing rules. While practice is inconsistent in this regard, these efforts may be partially responsive to investor desires.

OCA staff has been working closely with staff from our Division of Corporation Finance and others throughout the Commission to consider our existing disclosure requirements, current audit committee disclosure practices, and publicly available observations and commentary. This is an area I’ve devoted substantial time to since my arrival, and I look forward to further developments in this area.

Closing

I appreciate the opportunity to share my remarks to you today at this important conference. Thank you for your attention, and please enjoy the rest of the conference.
I am honored to be here today to discuss how stakeholders view the internal audit function. We, at the PCAOB, have many aligned and common interests with internal auditors at public companies.

Those common interests include promoting reliable financial reporting, strong internal controls, and high quality financial audits — all necessary to promote confidence and integrity in the securities markets while protecting investors and the public interest.

We also have common stakeholders, including investors, audit committees, CFOs and other business leaders, and external auditors, although the nature of our relationships with them are different.

Before I go further, let me say that the views I express today are my own and do not necessarily reflect those of the Board, other Board Members, or the staff of the PCAOB.

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Internal auditors and the PCAOB are part of the larger ecosystem of key actors who have roles and responsibilities in assuring effective and efficient capital markets. To best achieve these objectives, we each need to do our part.

Today I'd like to provide my perspective on the relationships among some of these key actors, or stakeholders, and the contributions that internal auditors make to the assurance process. I will also touch on PCAOB inspection results involving the external auditor's use of the work of internal audit.

My key message to you today is that internal audit is vital to the overall assurance framework, including the external audit process, and I encourage internal and external auditors to continue to engage effectively throughout the process.

IIA's "Three Lines of Defense" and the PCAOB

In its "Three Lines of Defense" model, the IIA presents a compelling case for the importance of effective and efficient coordination among the components of a company's risk management and control structure.

It describes a "systemic approach" made up of three lines of defense within a company to "coordinate essential risk management duties:" (1) management control, (2) management's risk and compliance oversight functions, and...
(3) internal audit. The model defines senior management and governing bodies (including audit committees) as the primary stakeholders for these three lines of defense.


As the IIA acknowledges in its paper, external auditors, regulators, and other external bodies have an important influence in a company's governance and control structure, and "when coordinated effectively [they] can be considered as additional lines of defense." [IIA]
The PCAOB is one such regulator, overseeing the external auditors of public companies trading in U.S. markets. The diagram below depicts the relationship of PCAOB regulation and the external audit to the three-lines-of-defense model.

**PCAOB and External Audit Relationships to the Third Line of Defense**

![Diagram](http://pcaobus.org/News/Speech/Pages/03092015_IIA.aspx)

*Source: PCAOB Board Member Jeanette M. Franzel. Adapted, with permission, from the Institute of Internal Auditors.*

The connections, aligned interests, and common stakeholders of the PCAOB and internal audit are evident. A fairly direct connection exists through internal audit's involvement in and coordination with the external financial audit, which is subject to PCAOB inspection.
Another connection is through the company's audit committee, which oversees both internal and external audit functions. The audit committee is a shared stakeholder.

In 2012, the PCAOB began an initiative under its strategic plan to enhance its outreach to and interaction with audit committees. The goal was and is to constructively engage to further our common interests, including audit quality and auditor independence. The Board continues to focus on this initiative as a high priority.

Needless to say, internal audit plays an important role in this system of assurance and oversight.

**PCAOB Inspections and Internal Audit**

We all know — and IIA survey results and other data bear this out — that internal auditors frequently provide needed support to the external audit, and external auditors use that work as evidence to support their own audit work and conclusions.

This is consistent with what we see in our inspections. As a result, PCAOB inspection procedures often involve looking at whether a firm appropriately used the work of internal auditors. For example, if PCAOB inspectors select revenue as a focus area in an inspection, and the audit engagement team used the work of internal auditors (or others) to support its own work, the PCAOB would inspect the totality of the work performed in auditing revenue, including how the external auditor used the internal auditor's work as part of the overall audit procedures for that audit area.

In addition to looking at the totality of the audit work for a given audit area, such as revenue, inspectors specifically consider how the external audit team met the requirements set forth in PCAOB standards for using the work of internal auditors. 

In those situations, our inspectors ask the following questions, based on the standards:

- Did the external audit team evaluate the objectivity and competence of the individuals performing the work?
- Did the external audit team consider materiality, the risks of material misstatement, and the degree of subjectivity involved when assessing the extent to which it used the work of internal auditors?
- Did the external audit team evaluate the quality and effectiveness of the work performed by internal audit?

With that background, I will say that, overall, our inspection results regarding the external auditor's use of internal auditors' work are relatively positive.

For the U.S.-based member audit firms of the six largest global networks, the number of audit deficiencies involving the external auditors' use of internal auditors' work is low overall; and it is low on a relative basis as well, when compared to other frequently cited deficiencies and to the total number of deficiencies identified through our inspections.

The table below summarizes the deficiencies related to the external auditor's use of the internal auditor's work in relation to overall inspection results.

<table>
<thead>
<tr>
<th>Inspection Year</th>
<th>Total Audits Inspected; U.S.-Based Global Network Firms</th>
<th>Inspected Audits with Deficiencies Included in the Public Inspection Report</th>
<th>Inspected Audits with Deficiencies Related to Use of Internal Auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>283</td>
<td>104</td>
<td>6</td>
</tr>
</tbody>
</table>

http://pcaobus.org/News/Speech/Pages/03092015_IIA.aspx 5/21/2015
a — Generally, inspection reports for these firms were issued in the calendar year following the inspection year. In general, audits inspected during the inspection year were audits for fiscal years that ended during the prior calendar year.

b -- These deficiencies relate to the external auditor’s use of the internal auditor’s work under AS No. 5, paragraphs 16-19, and AU sec. 322.

Common findings involving the use of internal audit work generally fall under the following themes:

- The auditor did not obtain an understanding of the nature, timing, and extent of the procedures performed by internal audit and failed to test internal audit’s work.
- The auditor failed to appropriately respond to the nature of the evidence and the specific audit findings provided by internal audit.
- The auditor used the work of internal audit but did not perform any work or performed only very limited work in cases where additional work should have been done by the external auditor.
- The extent of the auditor’s use of internal audit’s work was inappropriate, given the significance and risk associated with that audit area and the fact that the auditor conducted little or no testing of the area.

Here is a list of the inspection reports and the corresponding audits that included the deficiencies involving the use of internal audit work noted above. These are all on our website if you’d like to read more details on these issues.

<table>
<thead>
<tr>
<th>Audit Firm Inspection Report</th>
<th>Issuer Audits with Deficiencies Involving Use of Internal Audit Work</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 BDO USA LLP</td>
<td>Issuer B</td>
</tr>
<tr>
<td>2011 Deloitte &amp; Touche LLP</td>
<td>Issuer I</td>
</tr>
<tr>
<td>2012 Deloitte &amp; Touche LLP</td>
<td>Issuer A</td>
</tr>
<tr>
<td>2013 Deloitte &amp; Touche LLP</td>
<td>Issuers K and L</td>
</tr>
<tr>
<td>2011 Ernst &amp; Young LLP</td>
<td>Issuer B</td>
</tr>
<tr>
<td>2013 Ernst &amp; Young LLP</td>
<td>Issuers B and O</td>
</tr>
<tr>
<td>2011 Grant Thornton LLP</td>
<td>Issuer B</td>
</tr>
<tr>
<td>2012 Grant Thornton LLP</td>
<td>Issuers D and F</td>
</tr>
<tr>
<td>2013 KPMG LLP</td>
<td>Issuer B</td>
</tr>
<tr>
<td>2011 PricewaterhouseCoopers LLP</td>
<td>Issuers B, C, and Y</td>
</tr>
<tr>
<td>2012 PricewaterhouseCoopers LLP</td>
<td>Issuer J</td>
</tr>
</tbody>
</table>
In addition to the above deficiencies related to the external auditor's use of the work of internal audit under AS No. 5, paragraphs 16-19, and AU sec. 322, there were also several deficiencies in which the external auditor did not properly respond to internal control deficiencies detected by internal auditors. (See AS No. 5, paragraphs 62-70.)

Even though internal audit-related deficiencies do not appear in PCAOB inspection reports as frequently as other types of audit deficiencies, the issue is serious when the external auditors' use of internal audit work does not meet PCAOB standards and results in insufficient evidence to support the external audit opinion.

Such scenarios may indicate a lack of effective coordination and should be of great concern to an audit committee in its oversight of both the internal and external audit functions.

If your company's audit has been cited for a deficiency in the use of internal audit's work, you can take the lead by working with the external auditor and the audit committee to help ensure that the external audit team has what it needs from you on a timely basis. Although compliance with PCAOB standards is the responsibility of the external auditor, both internal audit and the audit committee have an interest in making sure that the auditors properly use and evaluate the work of internal auditors.

Internal auditors are in a position to have a significant positive impact on the external audit by making sure that the communication and coordination with the outside auditor and the audit committee run smoothly and swiftly.

Because of the seriousness of this issue, the topic, "Using the Work of Others," was discussed in a PCAOB Staff Audit Practice Alert No. 11, Considerations for Audits of Internal Control over Financial Reporting, issued a year and a half ago (October 2013), and audit firms have been taking steps to help ensure that they are following PCAOB standards in this area.

I want to stress the importance of getting this right. I am disappointed to hear anecdotal accounts of external auditors choosing to reduce or avoid reliance on the work of internal audit, regardless of risk, in an attempt to avoid a potential PCAOB finding in this area. Such an approach removes professional judgment from the process, potentially causes gaps in the system of assurance over financial reporting, and can put even more stress on an already stressed external audit team.

Letting the pendulum swing too far is not a solution audit firms should be using to respond to PCAOB findings in this area. Essential value will be lost if external auditors simply avoid the use of internal auditors' work or turn this process into a massive duplication effort and check-the-box documentation exercise.

Effective use of internal audit work to support the external audit enhances assurance not only through the external audit process, but also enhances internal audit's knowledge and experience that can be applied across its assurance functions as the "third line of defense."

I am pleased to see that the IIA's 2015 Pulse of Internal Audit report deals with this issue in some depth. The "Strategic Considerations for Internal Audit" included in the report include a great set of questions for internal auditors to use as a starting point when collaborating with external auditors and audit committees.

I urge external auditors, internal auditors, and audit committees to continue to seek ways to use internal audit effectively in order to maximize the benefits of an integrated system of assurance, including the value added by internal audit to the external audit function.

Ultimately, all of these functions must work effectively, and work effectively together, to protect investors.

**PCAOB Outreach to Audit Committees is Relevant to Internal Audit**
The PCAOB also reaches out directly to audit committees to pursue our common interest in achieving high quality audits. The Board's engagement with audit committees involves two fundamental components: listening to audit committees to understand their priorities, needs, and concerns; and exercising the Board's oversight activities to make sure that auditors are communicating effectively with audit committees about the audit. These activities cascade across PCAOB's programs and operations.

Because you, as internal auditors, support the audit committee and often interact with outside auditors, you are sitting in a seat of tremendous opportunity to be proactive and add significant value to the process. I have been privileged to be invited by some audit committees to visit with them and see firsthand this valuable coordination, as well as the overall heavy workload and concerns of audit committee members. I have also had the privilege to interact with many of you and gain an appreciation for the contributions that you make to this system.

In addition, we, at the PCAOB, benefit from the insight and perspectives of audit committee members through a variety of venues, including:

- Formal meetings of the Board's Standing Advisory Group, on which many members of audit committees serve, to discuss matters related to the Board's professional standards as well as other PCAOB-related issues;[7]
- Roundtables and other public meetings to discuss standard-setting topics, such as the auditor's reporting model and auditor independence, at which members of audit committees and governance bodies participate;
- Rulemaking, consultation papers and other activities through which we ask questions and solicit data related to the needs and interests of audit committees;
- Discussions with audit committee members about potential enhancements to our inspection reports and on the potential use of audit quality indicators;
- Conferences and events at which we participate to engage with the corporate governance community about PCAOB's programs and activities; and
- Global dialogue with foreign regulators and audit committee members about audit quality, at events such as those hosted by the International Forum of Independent Audit Regulators.

Through this outreach, I have heard a number of consistent themes from audit committees and their members that center around the increasing levels of stress in the system, involving audit committees' increased workloads and the increased risk and complexity of the many issues that companies are currently facing. These issues include cybersecurity risks, geopolitical conflicts and uncertainty, economic volatility, increasing regulatory scrutiny and new initiatives, and operational risks.

At the same time, audit committees tell us that they are dedicating significant time and effort to maintaining a focus on the core functions of overseeing financial reporting, internal controls, and the audit functions. To that end, many audit committee members have asked the PCAOB for more timely and targeted information about our oversight results, as well as analysis that provides useful insights that audit committees can immediately apply in their day-to-day activities.

The PCAOB is taking steps to respond to such calls. Stay tuned.

There is also an opportunity here for internal auditors. A recent global audit committee survey indicates that audit committees are generally satisfied with the value that internal audit delivers to their companies, with some room for improvement. In fact, audit committees are looking to internal audit for greater value. [8]
I believe it is well worth the time and effort for internal audit functions to formally assess their own performance on a regular basis, including getting the perspectives of the audit committee.

In my view, internal auditors are uniquely positioned to make significant contributions to audit committees as they face the challenges of the current business environment and its related risks. The opportunity is enormous, given internal audit's responsibilities across a company for performing risk assessments, developing risk-based audit plans that cover a full range of operational and financial risks, conducting those audits, and performing work to support the external audit.

In addition, internal audit can use the knowledge and insights gained from their work to further analyze and address other issues related to strategic and business risks and corporate governance.

So you see I have a high regard for internal auditors and their role in the financial ecosystem.

**Update on the "Perfect Storm" in ICFR**

Lastly, I want to update you on my theme from last year's conference, at which I discussed the "perfect storm" developing in internal control over financial reporting. That storm was brewing as management, internal auditors, and external auditors were implementing the 2013 COSO Internal Control Framework at the same time that external audit firms were taking steps to respond to PCAOB inspection findings on their audits of internal control. External auditors were responding to PCAOB inspections that detected a high level of deficiencies in internal control audit work.

A year later, I think it is fair to conclude that we are weathering the storm well. During the past year, auditors have focused on improving the quality of their audits of internal control over financial reporting while companies have focused on adopting the updated COSO framework.

Preliminary results of the 2014 inspections indicate that some improvements have been seen in the area of auditing internal control. That is positive news, especially given the significant changes that were occurring for both management and the auditors.

Recently, the head of inspections at the PCAOB, Helen Munter, reported that 2014 inspections have shown some promising overall improvements in the audit work performed at many firms. We are starting to see a downward trend in the number of findings and the nature (severity) of findings in some firms, and this includes findings in the area of auditing internal control over financial reporting.

We've seen some improvements in the assessments of the risks of material misstatement and identification of the appropriate controls to address those risks. But we continue to find persistent deficiencies in the testing of those controls, particularly controls that have a review element associated with them.

I will caution you, though; more strides still need to be made by audit firms here, as auditing internal control is still the most frequent area of inspection findings.

Internal control over financial reporting is an area for which is it very important to achieve the right balance and "get it right" through the entire financial reporting and auditing chain. To the extent that external audit deficiencies persist in this area, investors are not provided with sufficient assurance or information about the effectiveness of a company's internal control over financial reporting.

A strong set of internal controls, the "First Line of Defense" in the IIA's model, is key to providing assurance over the integrity and fairness of financial reporting. External audits under Auditing Standard No. 5 are designed to provide investors and other stakeholders with an opinion on the effectiveness of the company's internal control.
over financial reporting, and information about whether material weaknesses in internal control exist as of the date of management's assessment.

Although we are seeing positive indications in the audit of internal control over financial reporting, this is an area where all parties need to remain vigilant and continue to strive for improvements.

Concluding Thoughts

Internal audit is frequently a key part of an effective external audit, and I again encourage internal auditors and external auditors to continue to collaborate effectively throughout this process.

So, here we are: internal auditors, audit committee members, regulators, and external auditors in this audience — protecting investors, company shareholders and employees, and the integrity of our financial system, one audit at a time.

This conference presents a fantastic opportunity to advance the dialogue on these important topics. I look forward to continued progress as we work toward our common goals of assurance and integrity throughout the financial reporting and auditing chain.

[4] These six firms are BDO USA LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; and PricewaterhouseCoopers LLP. For more information on global networks of registered audit firms, see http://pcaobus.org/Registration/Firms/Pages/GlobalNetworkFirms.aspx.
[7] See, for example, the meeting of the SAG, on May 16, 2013, in which the Board sought feedback on its approach to engaging with audit committees, http://pcaobus.org/News/Events/Pages/05152013_SAG.aspx.

© Copyright 2003 - 2015 Public Company Accounting Oversight Board. All Rights Reserved.
I am honored to be here today to discuss topics of mutual interest to chief audit executives, audit committee and board members, financial and executive management, and the Public Company Accounting Oversight Board (PCAOB) in our complementary roles of achieving reliable financial reporting and audits to promote confidence and integrity in the securities markets. I believe that effective dialogue and interaction among all stakeholders in the financial reporting chain contribute to furthering the interests of investors.

Before I get started, I must tell you that the views I express today are my own and do not necessarily reflect the views of the Board, any other Board member, or the staff of the PCAOB.

We are currently in a "perfect storm" in the area of internal control over financial reporting, which demands effective action by all participants in the financial reporting and auditing chain. Management, internal auditors, and external auditors will be navigating the updated Committee of Sponsoring Organizations of the Treadway Commission (COSO) "Internal Control — Integrated Framework" at the same time that external audit firms are taking steps to respond to PCAOB inspection findings associated with their audits of internal control. [1]

Unfortunately, over the decades, we've seen multiple cycles in which company management and internal and external auditors simply didn't get it right in the area of internal control, resulting in failures to effectively define, understand, implement, and assess internal control.

Currently, after more than a decade of implementation of the internal control requirements of the Sarbanes-Oxley Act, we are faced with an opportunity to take a fresh look at internal control over financial reporting to prevent and detect material misstatements, and protect investors. This fresh look necessarily will involve management, internal auditors, external auditors, audit committees, and the PCAOB.
working together constructively to fulfill our respective responsibilities in the system of assurance over financial reporting.

Today I'd like to discuss significant trends and emerging issues in audits of internal control over financial reporting and related PCAOB inspections issues. I hope to dispel some mythology regarding PCAOB actions; provide some possible approaches for effectively navigating these issues; and encourage constructive communications between public companies and their audit firm as management considers potential changes to internal control based on the updated COSO Framework.

**Trends in Audits of Internal Control Over Financial Reporting**

Before we dive into the PCAOB's recent actions related to audits of internal control over financial reporting, here is a quick quiz on PCAOB standards, recent guidance, and inspection findings related to ICFR audits.

<table>
<thead>
<tr>
<th>Question Number 1:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Which of the following statements is true?</td>
</tr>
<tr>
<td>a. PCAOB recently has changed the standards for auditing internal control;</td>
</tr>
<tr>
<td>b. PCAOB recently has promulgated new rules for audits of internal control; or</td>
</tr>
<tr>
<td>c. PCAOB has not changed the standards or the rules in this area in recent years.</td>
</tr>
<tr>
<td>The correct answer is &quot;c.&quot;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Question Number 2:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the following statement true or false?</td>
</tr>
<tr>
<td>a. PCAOB's inspections approach related to internal control over financial reporting has changed over the years.</td>
</tr>
<tr>
<td>The correct answer is &quot;true.&quot;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Question Number 3:</th>
</tr>
</thead>
<tbody>
<tr>
<td>In which year(s) did PCAOB's inspections approach change related to internal control over financial reporting?</td>
</tr>
<tr>
<td>a. 2006</td>
</tr>
<tr>
<td>b. 2008</td>
</tr>
<tr>
<td>c. 2010</td>
</tr>
<tr>
<td>d. 2012</td>
</tr>
<tr>
<td>The correct answers are a, b, and c.</td>
</tr>
</tbody>
</table>
It is important to understand both the evolution of major changes in PCAOB auditing standards for internal control audits from 2004 to 2007, as well as changes in the PCAOB's inspections approach, so stakeholders can be in the best position to "get it right" on internal controls.

PCAOB inspection results have provided evidence and insights into areas where external auditors need to strengthen audits of internal control to comply with existing standards. Appropriately, audit firms are taking actions to strengthen ICFR audits. I believe that we are currently well-positioned in terms of achieving strengthened audits over internal control based on the evolution of changes in PCAOB standards and inspection activity since the initial standards were issued in 2004. [a]

Here is a brief chronology of PCAOB standards and inspection activities related to internal control over financial reporting.

- **2004** - The Board adopted Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS 2), to govern the newly required audit of internal controls. [a]

- **2006** - On May 1, the Board issued a statement announcing it would focus on how efficiently the firms performed audits according to AS 2. [a] At that time, PCAOB inspections were focused on efficiency, including (1) the degree of integration between the audit of ICFR and the financial statements; (2) the auditor's use of a top-down approach; (3) the proper assessment of and response to identified risks; and (4) using the work of others. [5] Through inspections and other monitoring, PCAOB determined that, although the audit of internal control over financial reporting produced benefits, those benefits came at a significant cost. [6]

- **2007** - On June 12, the Board adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5), to improve implementation of ICFR audits. AS 5 became effective for audits for fiscal years ended on or after Nov. 15, 2007, and emphasizes a top-down, risk-based audit approach that focuses on the most important audit matters. [7] It also eliminated unnecessary audit procedures, and was designed to be scalable to the size and complexity of the business. [8]

- **2008** - The PCAOB's 2008 inspections of ICFR audits focused on whether auditors were effectively transitioning to AS 5. During inspections fieldwork, inspections teams communicated specific observations to the audit teams and discussed overall observations for each firm with the firm's leadership. Inspection findings related to ICFR were not reported in individual firm inspection reports, but were summarized in a general report issued by the Board. [9]

- **2009-2010** - The Board continued to monitor the execution of AS 5 and its inspections focused on whether firms had obtained sufficient audit evidence to support audit opinions on the effectiveness of ICFR. Beginning primarily in the
2010 inspections cycle, when inspections staff found deficiencies in the auditor's testing of the design and/or the operating effectiveness of internal controls, those deficiencies were communicated to the audit firms primarily through comment forms and then reported, as appropriate, in the firms' inspection reports.

**Recent Board Reports and Guidance Regarding ICFR Audits**

Due to the Board's concerns about the number and significance of deficiencies in firms' audits of ICFR in the 2010 and 2011 inspections, in December 2012, the Board issued a report, *Observations from 2010 Inspections of Domestic Annually Inspected Firms regarding Deficiencies in Audits of Internal Control over Financial Reporting.* [1]

The report provides information about the nature and frequency of deficiencies in firms' audits of internal control detected during the PCAOB's 2010 inspections of eight domestic registered firms that have been inspected every year since the PCAOB's inspection program began. [1] The report's findings include:

- In 46 of the 309 integrated audit engagements, or 15 percent, that were inspected in 2010, inspections staff found that the firm, at the time it issued its audit report, had not obtained sufficient audit evidence to support its audit opinion on the effectiveness of internal control due to one or more deficiencies identified by the inspections staff.

- In 39 of those 46 engagements, or 85 percent, where the firm did not have sufficient evidence to support the internal control opinion, the firm also did not obtain sufficient audit evidence to support the financial statement audit opinion. These engagements represent 13 percent of the 309 integrated audit engagements that were inspected.

- These deficiencies also revealed weaknesses in some firms' systems of quality control of such significance that, in the Board's view, they required remediation.

The Board's inspections staff continued to observe high levels of deficiencies in the audits of internal control during the 2011 inspections of these eight firms (generally covering fiscal year 2010 audits).

On Oct. 24, 2013, the PCAOB issued Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting,* in light of significant ICFR auditing practice issues observed by the inspections staff over the past three years. [2]

The practice alert discusses the application of certain requirements of AS 5 and other PCAOB standards to specific aspects of the audit of internal control. Significant auditing deficiencies in audits of internal control that have been cited frequently in PCAOB inspection reports include deficiencies where the audit firm did not:

- Identify and sufficiently test controls that are intended to address the risks of material misstatement;
Sufficiently test the design and operating effectiveness of management review controls that are used to monitor the results of operations;

Obtain sufficient evidence to update the results of testing of controls from an interim date to the company's year-end (i.e., the roll-forward period);

Sufficiently test controls over the system-generated data and reports that support important controls;

Sufficiently perform procedures regarding the use of the work of others;

Sufficiently evaluate identified control deficiencies.

The practice alert also discusses potential root causes of the deficiencies, and provides guidance for auditors in areas including:

- risk assessment and the audit of internal control;
- selecting controls to test;
- testing management review controls;
- information technology considerations, including system-generated data and reports;
- roll-forward of controls tested at an interim date;
- using the work of others;
- evaluating identified control deficiencies.

In many of the audit deficiencies that inspections staff detected, firms were not appropriately following their own methodologies for audits of internal control over financial reporting.

**Emerging Issues in Audits of Internal Control Over Financial Reporting**

So although the PCAOB has neither changed the auditing standards nor introduced new rules for audits of internal control over financial reporting since the issuance of AS 5 in 2007, many issuers are experiencing changes in firms' audit approaches as a result of PCAOB inspections and the recent guidance in Audit Practice Alert No. 11. In some cases, auditors are performing additional procedures related to previously issued audit opinions on ICFR.

In some cases, the following situations are occurring, in which auditors are adding or changing ICFR audit procedures:

- **The auditor changes the ICFR audit approach for audits that were not inspected or for audits that were inspected, but did not have ICFR-related deficiencies reported in Part I of the firm's PCAOB inspection report.**

  Firms may be making changes to their audit approaches as part of the remediation of a quality control deficiency noted in Part II of the inspection report. Such changes could involve additional staff training to achieve compliance with the firms'
existing audit methodology for auditing ICFR; the implementation of new audit tools or updates to the audit methodology; or mandating the use of certain audit procedures in cases where those procedures had been optional.

In addition, firms may be implementing changes in their audits of ICFR in reaction to the PCAOB's December 2012 report that summarized deficiencies in firms' ICFR audits, as well as the additional guidance provided in Audit Practice Alert No. 11. The PCAOB issued both of these documents because of a high number of ICFR findings across many inspected firms. The report and the practice alert should have caused firms to reassess their ICFR approach and make any necessary changes to improve quality and make sure their audits are consistent with the requirements of AS 5.

- The auditor performs additional procedures for a previously completed audit after a PCAOB inspection.

A firm might also be performing additional procedures specifically because a deficiency was identified and included in Part I of the firm's inspection report, and the firm seeks to determine whether, following performance of the necessary procedures, it can still support its previously expressed opinion on ICFR.

The PCAOB has heard that in response to some of the above changes, some issuers have expressed concerns about the value of additional audit work in the ICFR area, and whether there will be significant increases in costs as a result.

We also have received feedback that would indicate there has not been effective communication and dialogue between audit firms and issuers about ICFR issues. In some cases, audit firms have told issuers that the PCAOB insists on detailed procedures such as the use of "screen prints" to document certain systems-related features; or specifying the number of pages that must be involved in summarizing key controls; or that auditors must attend management meetings to observe certain controls in action. I assure you that the Board is not requiring procedures at that level of detail. AS 5 provides the guiding standard for ICFR audits.

Unfortunately, such responses from audit firms tend to close down the dialogue with financial statement preparers about important basic issues such as identifying key controls, establishing the appropriate level of management documentation and testing, and the nature and extent of auditor testing needed to support the auditor's ICFR opinion.

Productive dialogue between the audit firm and financial statement preparers is necessary to coordinate management's responsibilities to implement effective ICFR and assess its effectiveness, and the auditor's responsibilities to audit and report on ICFR.

Experienced auditors and financial statement preparers know that the ICFR audit is made more difficult if management's process is not as effective or well-documented as it should be. Effective and efficient solutions to some of the audit deficiencies found by the PCAOB may also require some improvements to both the issuer's and the auditor's process. I am concerned that, in some cases, the auditor's reaction is to "bolt on" a
series of new audit steps when a more efficient and effective solution may require some tightening up of the controls on the part of management, in addition to changes to the audit procedures.

The Securities and Exchange Commission's Deputy Chief Accountant recently expressed concern that some of the PCAOB's inspection findings related to the audits of internal control over financial reporting are likely indicators of similar problems with management's evaluations of ICFR, and thus potentially also indicative of risk for unidentified material weaknesses. He further stated that he has heard suggestions that auditors and the PCAOB have higher expectations than management when considering the adequacy of entity-level controls or the severity of control deficiencies. [17]

Meanwhile, the PCAOB has heard from some issuers concerns that audit firms may take a checklist approach to the audit to map controls to the principles articulated in the 2013 COSO Framework. And we also have heard speculation that firms are taking such an approach because they are worried that PCAOB inspectors will inspect against the points in the 2013 COSO Framework.

I am concerned that a checklist approach to the 2013 COSO Framework would result not only in a missed opportunity to take a fresh look at management's and the auditor's approaches to evaluating and auditing internal control, but also that such an approach could increase the likelihood of missing new and evolving risks in financial reporting and the related auditing.

I will once again emphasize the importance of auditors following the top-down, risk-based audit approach in AS 5, along with the guidance in the Board's October 2013 audit practice alert, for conducting the audit. In addition, I believe it is necessary and productive to take a fresh look at management's process in light of the 2013 COSO Framework, so that the entire system functions effectively. And, of course, auditors and issuers need to have a productive dialogue about these issues.

Concluding Thoughts

The current "perfect storm" swirling around internal control over financial reporting demands the appropriate attention of all participants in the financial reporting and auditing chain. To achieve the assurance over ICFR that investors and the market rely on, all participants must do their part to fulfill their responsibilities for implementing, evaluating, and auditing internal control.

PCAOB inspection results have provided evidence and insights into areas where external auditors need to strengthen audits of internal control to comply with existing standards. Further, audit firms must continue strengthening their ICFR audits.

Meanwhile, management will be considering the 2013 COSO Framework in its implementation and assessment of internal control. Also, internal auditors can play a very important role in these efforts by taking a fresh look at internal control through the COSO Framework, and supporting management's efforts and the external audit process.
I look forward to working constructively with audit committees, issuers, and the audit firms to achieve the assurance needed from audits of internal control over financial reporting.


[2] The auditor attestation requirement applies to companies that qualify as "large accelerated filers" or "accelerated filers," other than "emerging growth companies." For a discussion of the evolution of requirements for certain public companies to undergo an audit of ICFR under Section 404(b) of the Sarbanes-Oxley Act of 2002, see Office of the Chief Accountant, Securities and Exchange Commission, "Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million" (April 2011).


[4] PCAOB Release No. 104-2006-105, "Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle" (May, 1, 2006), 1. An audit that achieves the objectives described in the Board's standards is "effective." "Efficiency" refers to the auditor achieving those objectives with the least expenditure of effort and resources.


[8] Ibid., 3-4. The Board's approach was coordinated closely with the SEC, which issued concurrent guidance to company management on a similar approach to evaluating internal control under management's responsibilities under Section 404(a) of the Sarbanes-Oxley Act (SEC Exchange Act Release No. 33-8810 (June 20, 2007)).


[13] Findings in Part II of PCAOB inspection reports, if any, describe deficiencies in the firm's overall system of quality control such that the Board has doubts that the system provides reasonable assurance that professional standards were met. The Board is
prohibited by law from publicly releasing Part II findings unless the firm fails to remediate
them to the Board's satisfaction within 12 months of issuance of the inspection report.


[161] Inspection findings related to audits of ICFR that are reported in Part I of PCAOB
inspection reports reflect PCAOB staff's view that the auditor failed to obtain reasonable
assurance about whether effective ICFR was maintained in all material respects. See
PCAOB Release No. 2012-003, "Information for Audit Committees about the PCAOB

[161] In the event the firm determines it cannot support its previously expressed opinion,
AS 5, paragraph 98, imposes certain obligations on the firm (incorporating certain
provisions of AU 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's

[171] Brian Croteau, "Audit Policy and Current Auditing and Internal Control
Matters" (remarks Before the 2013 AICPA National Conference on Current SEC and
PCAOB Developments, Washington, DC, Dec. 9, 2013)
Remarks Before the 2014 AICPA National Conference on Current SEC and PCAOB Developments

Brian T. Croteau
Deputy Chief Accountant, Office of the Chief Accountant

Washington, D.C.
Dec. 8, 2014

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Introduction

Good morning and thank you Brad [Davidson] for the introduction. As Deputy Chief Accountant for OCA’s Professional Practice Group (PPG), I am fortunate to have a talented and dedicated team of professionals who focus on audit quality and investor protection each and every day. We work closely with, and provide advice and support to, other offices and divisions within the SEC on auditing, auditor independence, and internal control matters. OCA’s PPG also has a significant role in leading and coordinating the Commission’s oversight of the Public Company Accounting Oversight Board (PCAOB). In doing so, we work very closely with the PCAOB throughout the year to achieve our shared investor protection objectives.

I’ll begin my remarks this morning with some observations from our ongoing focus on auditor independence and then move on to some PCAOB and internal control matters. Also, Jim Schnurr mentioned our work to consider updating audit committee disclosure requirements so on that topic I’ll simply add that I too am enthusiastic about these efforts. I anticipate this work will continue to be a priority for OCA’s PPG in 2015.

Continued Focus on Auditor Independence Matters

High-quality audits performed objectively by independent auditors support investor confidence in financial reporting. Independence in both fact and appearance is foundational to an audit and necessary to reduce threats to auditor objectivity and to promote credibility. As I’ve said many times, I believe the SEC’s existing independence rules, which were last amended to implement the provisions of the Sarbanes-Oxley Act, have served us well.[i] Reinforcing my belief, we continue to observe efforts around the world to emulate aspects of our independence rules.[ii]

Notwithstanding the years of experience we all have had with the existing independence rules, we continue to respond to many independence inquiries each year. For example, we receive numerous questions about non-audit services, partner rotation, and business and employment relationships. Many of them relate to novel fact patterns as practice evolves. Over the past couple of years we have seen an uptick in questions about broker dealer audits even though our independence rules have applied to these audits since 1975. OCA’s PPG has several staff members devoted to addressing your questions regarding auditor independence and I encourage you to continue consulting with us as you find appropriate. As we try to provide timely and helpful advice, we benefit because hearing...
from you helps the staff understand current practices and emerging issues. We interact routinely with auditors, management, and audit committee members given the responsibility these parties share for auditor independence. Information about OCA’s consultation process is available on the SEC website under Information for Accountants.[iii]

One of the questions I posed last year at this conference was whether management and audit committees have appropriate policies and procedures in place to evaluate the non-audit services provided by the company’s auditor. I mentioned that this evaluation should include monitoring the provision of non-audit services for the risk of “scope creep” that could result in a service becoming impermissible and impairing the auditor’s independence.[iv] I believe this reminder deserves repeating. Unfortunately, I am aware of at least one recent circumstance where a large accounting firm resigned from an issuer audit engagement because a purportedly permissible non-audit service was found to have deviated from its intended scope causing the auditor to impair its independence for the current period. When such issues occur, unplanned changes in auditors and potential reaudits can be costly and distracting to the company and its shareholders and can interfere with capital raising plans.

Another reminder that I feel compelled to repeat is that auditors of SEC-registered broker-dealers are required to be qualified and independent in accordance with the Commission’s auditor independence requirements in Rule 2-01 of Regulation S-X. Among other things, this means that auditors cannot both prepare and audit any part of the financial statements of a broker or dealer, including the statement of cash flows or the notes to the financial statements. Doing so is a violation of SEC independence rules.

Indeed, just this morning both the SEC and PCAOB announced the settlement of enforcement actions which include sanctions against numerous accounting firms that were found to have been involved in preparing financial statements and related notes of brokerage firms that were audit clients in violation of SEC rules. [v] I’m sure you will hear more about this topic from both SEC and PCAOB enforcement staff later in the conference.

While I’m mentioning broker-dealer audits, I should also note that in addition to long-standing SEC independence rules, several PCAOB independence rules began to apply to broker-dealer audits for the first time in June 2014. These new rules are in addition to the PCAOB’s audit and attestations standards. For example, PCAOB Rule 3526, Communications with Audit Committees Concerning Independence, now applies, which requires certain written communications and related discussions prior to acceptance of an initial engagement and then at least annually, or in some circumstances more frequently. The same is true for PCAOB Rule 3522 regarding tax transactions, which prohibits the provision of any non-audit service related to marketing, planning, or opining in favor of the tax treatment of certain transactions, including those that would be considered “aggressive tax position transactions.” Important information about these and other PCAOB rules for auditors of broker-dealers is available on the PCAOB’s website.[vi]

I’ll wrap up my independence comments by mentioning two matters that OCA worked together on with our colleagues in the Division of Enforcement. You will likely hear more about these matters from Andrew Ceresney and Mike Maloney during tomorrow’s SEC enforcement update. First, with respect to one matter involving a large accounting firm that loaned staff to its audit clients, the Commission issued a report of investigation[vii] that clarified that an auditor cannot provide otherwise permissible services, such as tax compliance services for example, in a manner that is prohibited by the rules. Acting as an employee or performing decision-making or monitoring functions is always prohibited. Also, providing loaned staff services results in an accountant
violating SEC independence rules by acting as an employee of the audit client, separate and apart from whether the accountant acted as a director or officer or performed any decision-making, supervisory, or on-going monitoring functions.

Although the Commission’s guidance may not specify whether a particular type of service is prohibited, neither the nature of the service nor the manner in which it is provided can be at odds with the principles in the Preliminary Note of Rule 2-01. As a reminder, always consider whether a relationship or service provided by an auditor:

- creates a mutual or conflicting interest with their audit client;
- places them in a position of auditing their own work;
- results in acting as management or an employee of the audit client; or
- places them in a position of being an advocate for the audit client.

Speaking of advocacy, this brings me to the second enforcement matter I want to mention. Earlier this year a large accounting firm agreed to settle charges that a subsidiary of the firm had lobbied congressional staff on behalf of two audit clients.[viii] These activities are impermissible because they put the firm in the position of serving as an advocate for its audit clients. In this case, the firm had asked congressional staff to insert language into a bill that was favorable to the business interests of an audit client. While these facts speak for themselves, I want to emphasize that advocacy can take many forms; it doesn’t need to involve Congress or necessarily be labeled as lobbying, and it is inconsistent with maintaining independence in both fact and appearance.

With all of this in mind, auditors should continue to evaluate and apply the independence rules carefully and ensure that partners and staff, including those responsible for providing non audit services, receive sufficient training on auditor independence rules and that necessary oversight and monitoring is in place. Audit committees as well should be vigilant in carefully considering risks when fulfilling their preapproval responsibilities and, where appropriate, should establish ongoing monitoring to help avoid the types of issues I have described emanating from decisions to proceed with services that may pose scope creep threats.

**PCAOB Matters**

You’ll hear from Chairman Doty, Board Member Hanson, and staff of the PCAOB later in the conference but I’d like to make a few observations given that the oversight of and collaboration with the PCAOB is a significant part of OCA’s PPG’s work.

First, as Jim [Schnurr] mentioned, for the past few years I have been encouraging quicker progress on updates to audit performance standards.[ix] I mentioned that standards such as auditing estimates, including fair value measurements, and use of other auditors and specialists, have all been on the PCAOB’s agenda and talked about at various meetings for several years but have not advanced to a public proposal. As I’ve said before, my view is that there has been enough talk about the need to update these standards and it is time to make progress by advancing these projects to proposals for public input. Another year has passed on these particular projects with no public proposals. I am pleased the PCAOB recently adopted, and the Commission approved, Auditing Standard No. 18, which address auditing of related party and significant unusual transactions, and the PCAOB also advanced a staff consultation paper on auditing estimates, including fair value. However, I have an increasing degree of concern about the slow pace of advancing important auditing and quality control projects and I once again hope to see more
accomplished in 2015. I also look forward to working with Jim and the PCAOB Board and staff on to consider longer term improvements to the PCAOB's standard setting process as Jim mentioned earlier.

Second, I am pleased to see the PCAOB's Offices of the Chief Auditor and Research and Analysis working together to develop and implement policies and practices to embed economic analysis more formally into the PCAOB's rulemaking efforts. Consistent with remarks I've made over the past years about root cause analysis and what I call the "audit performance feedback loop," I am also pleased to see the PCAOB advance its focus on root cause analysis of auditor behavior. In light of the behavioral nature of auditing, including the importance of the application of due care and professional skepticism, I have become very interested in the recent emergence of some insightful work in the academic community. For example, I noted that a recent academic paper on the Social Sciences Research Network (SSRN) titled, "The Way Forward on Professional Skepticism: Conceptualizing Procesional Skepticism as an Attitude" quickly became one of the ten most downloaded papers. Behavioral audit research that can likely follow may help improve our understanding of fundamental root causes of audit deficiencies and facilitate development of amendments to auditing standards that are most likely to effectively and efficiently achieve their intended result.

My third and final observation on PCAOB matters, which may indeed be related to the prior point, is to commend the PCAOB for the recent improvements made to the content of inspection reports. One change that I believe to be particularly useful is the addition of references to specific paragraphs of PCAOB standards that are the subject of auditor performance criticisms in inspection findings. I believe this addition provides readers of the reports with helpful context for both the nature and severity of the criticism. In addition, a new appendix (Appendix D) has been included in the reports of annually inspected firms that summarizes the auditing standards referenced within the inspection reports.

I believe this appendix could be particularly useful for audit committees to promote meaningful discussions with auditors about whether and how those same standards are being applied on their engagements to help to address or avoid similar issues. I understand that some professors are also using this new appendix in the classroom to help tomorrow's auditors learn from today's mistakes. I also understand thought is being given by some in the academic community about the ways this new data can be used to inform audit research.

I know that the PCAOB is likewise continually considering how its own use of the data can be enhanced. I suspect that together we will be able to more easily identify areas within auditing standards deserving focus and inform thinking about the nature of changes that are most likely to improve quality. This of course includes considering whether to clarify or build out aspects of a standard in ways that decrease the likelihood that an auditor would issue a report without performing necessary procedures.

Let me move on briefly to internal control over financial reporting (ICFR).

**Internal Control Over Financial Reporting (ICFR) — Where are the Material Weaknesses?**

Last year I discussed that we are working together throughout OCA as well as with other offices and divisions on ICFR matters. I questioned whether material weaknesses were being properly identified and disclosed; mentioned that OCA planned to continue our close work with Corp Fin, the PCAOB, and Enforcement to address these matters; and noted it was surprisingly rare to see management
identify a material weakness in the absence of a material misstatement. I suggested these results could either stem from deficiencies not being identified in the first instance or from the severity of deficiencies not being evaluated appropriately.[xi]

On the next panel after the break, Kevin Stout, a Senior Associate Chief Accountant in OCA’s PPG, will discuss some observations from our work with Corp Fin and the PCAOB over the last year. He will touch on COSO’s updated framework, management’s identification and consideration of financial reporting risks in their annual ICFR evaluations, and some specific concerns about how the nature of deficiencies are described and their severity evaluated. You’ll also hear more from staff in our Division of Corporation Finance on this topic tomorrow.

On the enforcement front tomorrow you’ll be hearing more about a number of ICFR enforcement case, including one where the SEC charged the CEO and CFO of a public company who mislead its auditors by withholding information about internal control deficiencies.[xii] The CEO of the same public company did not participate in management’s evaluation of its internal controls despite contrary representations in its Form 10-K. Both the CEO and CFO signed the Form 10-K containing a false management report on its controls as well as signed false certifications in which they represented they had evaluated the report and disclosed all significant deficiencies to the auditors.

Suffice it to say, based upon our cumulative efforts this year, I continue to question whether material weaknesses are being properly identified, evaluated, and disclosed. A take away you should have by the end of the conference is that our efforts throughout the SEC pertaining to the ICFR requirements are ongoing, coordinated, and increasingly integrated into our routine consultation, disclosure review and enforcement efforts.

I’ll wrap up with a final prospective point on ICFR. As companies work to implement the FASB and IASB’s newly converged standard on revenue recognition[xiii] it is important to give early and ongoing consideration to implementing new controls or redesigning existing controls where necessary. Given the special importance of properly accounting for revenue, to the extent changes are made to ICFR in advance of adoption that also relate to current period financial reporting, I’d also remind management to consider its quarterly obligations to disclose material changes to ICFR.

Thank you for your attention and I look forward to answering any questions on the end of day Q&A panel.


[iv] See Brian T. Croteau, op. cit.


Keynote Address

DATE:      May 1, 2015

SPEAKER:   Jay D. Hanson, Board Member

EVENT:     The Citadel Directors' Institute

LOCATION:  Charleston, SC

Good Morning,

First, let me thank you for inviting me to speak here today in the beautiful city of Charleston. I am pleased to have been included among such an impressive group of speakers at an event hosted by this historic institution, which trains the leaders of tomorrow, whether in business, the military, education or other areas.

I am a member of the Public Company Accounting Oversight Board and am based in our headquarters in Washington, D.C. Unlike the Citadel, with its long and distinguished history, the PCAOB is just over a decade old, having been created by Congress through the passage of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act”). Our mission is to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. We also oversee the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

The PCAOB began operations in April 2003 and has four main responsibilities:

1. Registration of public accounting firms;

2. Inspections of registered public accounting firms;

3. Setting of auditing standards for the audits of public companies and broker-dealers; and

4. Investigations and disciplinary proceedings in cases where auditors may have violated the securities laws or applicable standards or rules.

Today, I will provide a little more background about the PCAOB, along with some of the work we are doing that relates to public company directors and management. But before I go further, I should tell you that the views I express today are my personal views and do not necessarily reflect the views of the Board, any other Board member, or the staff of the PCAOB.

Background
Many of you probably know that the PCAOB was created in the wake of some of the largest and most infamous accounting fraud scandals in this country's history. Companies like Enron, WorldCom, Tyco, Adelphia and Xerox were in the news almost daily. At one time, these companies were rising stars. Unfortunately, the impressive financial results these companies reported, even after they were audited by a major public accounting firm, turned out to be erroneous and, in some cases, fraudulent. After the collapse of Enron, concerns about the effectiveness and accountability of that company's external auditor revived long-standing questions about the governance and independence of the public accounting profession. People questioned whether auditors could be sufficiently independent if they are hired and paid by management of the companies whose financial statements they are expected to audit. In addition, auditors were not subject to comprehensive government regulation, nor was their work subject to any other independent oversight. Although many firms participated in a peer review system, critics believed that these reviews were not sufficiently rigorous or independent to provide any real incentive for improvement.

When the bankruptcy of WorldCom followed soon after the collapse of Enron, Congress acted quickly to establish the PCAOB and impose a series of other requirements on public companies in order to revive confidence in the U.S. securities markets. In addition to establishing the PCAOB, the Act included a number of provisions intended to enhance the independence of auditors from company management. For example, the Act required that audit committees, not company management, appoint, compensate and oversee the work of the independent auditor. The Act restricted audit firms from performing certain types of non-audit services for their audit clients. And beyond these provisions related to auditors, the Act included a series of measures designed to improve corporate governance at public companies, including requirements that management certify the accuracy of reported financial statements and assess the effectiveness of the company's internal controls over financial reporting. The law also requires auditors to report on management's assessment of its internal controls.

The PCAOB began operations in April 2003 and is led by a five full-time Board members, each of whom is appointed by the U.S. Securities and Exchange Commission (“SEC”) to a five year term (with a maximum of two terms permitted). As mandated by the Sarbanes-Oxley Act, two of the five Board members must be Certified Public Accountants, and I was appointed in 2011 to fill one of these CPA positions. We operate under the oversight of the SEC, which, in addition to appointing Board members, must approve our budget and any rules and standards issued by the Board.

Since 2010 and the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB also has had oversight authority over the auditors of brokers and dealers.

Currently, almost 2200 public accounting firms are registered with the Board, including over 900 foreign firms from 85 jurisdictions.

Since commencing operations in 2003, the PCAOB has, among other activities:

- Conducted over 2500 inspections of firms that audit issuers, including inspections in 44 jurisdictions outside the United States;
- Conducted over 175 inspections of firms that audit broker-dealers under an interim
inspection program that began in 2010;

- Issued 18 auditing standards and substantially amended a number of others, including a standard addressing the auditor's responsibilities with respect to the company's internal controls over financial reporting;
- Sanctioned dozens of firms and individual auditors for violations of applicable federal laws, auditing standards, and SEC or PCAOB rules; and
- Issued public reports summarizing inspection findings, staff audit practice alerts to provide insight into common audit deficiencies or difficult audit issues, and other publications intended to provide information to the public and transparency about our work.

Outreach

In order to accomplish our objectives effectively and efficiently, and in the interest of transparency, the Board has made it a priority to conduct extensive outreach to the many stakeholders affected by our work. Of course, we provide ample opportunities for public comment on all of our rulemaking and standard-setting projects. This includes not just a process inviting written comments, but also round table discussions hosted by the Board on particular standard setting projects. For example, last year, the Board hosted a round table discussion focused on the Auditor's Reporting Model project, seeking input about a potential new requirement for auditors to disclose more information about individual audits.

In addition, we have long had a Standing Advisory Group — made up of investors, auditors, audit committee members, financial statement preparers, academics and others — to provide advice to the Board in connection with our standard setting activities. Several years ago, the Board also established an Investor Advisory Group to provide additional perspectives from investors, chaired by my fellow Board Member Steve Harris. We also do outreach to preparers of financial statements, including by attending and speaking at meetings and conferences for CFO’s, controllers, internal auditors and other financial executives. And in 2012, the Board announced a strategic priority to enhance its outreach to audit committees, in order to better understand how we can be helpful to audit committees and how they might be able to help us achieve our common goal of enhanced audit quality. In connection with that effort, Board members and senior staff from the PCAOB have attended and made presentations at many audit committee gatherings — large and small — where we have provided information and listened to feedback.

The reforms of the Sarbanes-Oxley Act put audit committees front and center in the financial reporting process, and their importance cannot be overstated. Indeed, last June, in the context of discussing two enforcement actions against audit committee members, SEC Chair Mary Joe White referred to directors of public companies as the "essential gatekeepers upon whom your investors and, frankly, the SEC rely." [1] Chair White stressed the fiduciary responsibility of directors and focused on the importance for directors to set an appropriate “tone at the top” for “good corporate governance and rigorous compliance.” If you have not yet read this speech, I urge you to take a look at it — Chair White has experience as a director and audit committee member herself, in addition to her current roles as a regulator and past experience as a federal prosecutor and securities lawyer, and she gives sound advice.
Our own dialog with audit committees has demonstrated that many audit committee members take very seriously their duties to oversee the audit and to help ensure integrity and accuracy in the financial reporting process. The audit committee members who have engaged with us are well-informed, experienced and interested in what we do. At the same time, we hear that there are still audit committee members whose primary focus is to support management and negotiate the lowest audit fee possible. Some audit committees, we hear, are not fully qualified to oversee the financial reporting process or external auditor, because of a lack of experience among committee members in accounting, auditing and financial reporting. While this is not within the PCAOB’s jurisdiction, some have urged that qualifications for the so-called “financial expert” on the audit committee be made more rigorous, in order to enhance the audit committee’s ability to provide effective oversight in these areas.

Of course, one thing we hear consistently from all audit committee members is that they are very, very busy. From cybersecurity to risk management, and from CEO succession planning to activist investors, audit committee members are faced with more work, and more variety of work, than ever before. In the near future, the SEC also is expected to seek public comment about possible new disclosure requirements by audit committees about their activities, including auditor oversight. A recent Wall Street Journal article may have gotten it right when it referred to audit committees as “the Board's fire department,” called in to deal with emergencies and high risk areas.

Combined with the ongoing responsibilities for auditor oversight and increasing complexity in accounting and financial reporting, the ever-growing list of audit committee tasks truly cause audit committees to be spread thin. Not surprisingly, then, one of the key messages from audit committees to us has been that any information we can provide should be relevant to them, provided on a very timely basis, and presented clearly and concisely. This has been the impetus for some of changes in our public documents, such as executive summaries in our summary reports of inspection findings, new charts and other reference sections in our firm specific inspection reports, and other information provided to help audit committees respond to our inspection findings. In addition, we are currently working on other periodic communication mechanisms to provide audit committee members with more timely and targeted information about relevant audit risks and related concerns.

Audit committee members, of course, often discuss the audit with their company’s respective management, who are on the receiving end of the actions auditors take in response to our regulatory activities. Sometimes, audit committee members tell us that they are hearing concerns from management about an uptick in auditors’ demands on financial reporting staff or about audit work that they don’t believe adds value to the audit. As a result, we are trying to make sure that we hear directly from preparers of financial statements about their concerns. My fellow Board members and I have been able to meet with groups of preparers through organizations like Financial Executives International, the Institute of Management Accountants, networks of controllers organized by audit firms or corporate governance organizations, meetings organized through the U.S. Chamber Commerce, and a variety of other meetings and conferences.

What we hear from the preparer community often echoes what we hear from audit committees, and the chief concern tends to be about increasing audit costs, both in terms of the fee paid to the auditor and the time spent by management responding to
information requests from auditors. Some believe that our actions are causing their auditors to spend more time than necessary on "busy work" or "check-the-box" compliance activities without adding much value to the audit process. Others believe that we are bringing back the more burdensome "Auditing Standard No. 2" in audits of internal controls, which was superseded in 2007 by Auditing Standard No. 5. We also hear that some auditors may not be performing effective risk assessments, but rather are treating all areas as high risk, doing extensive audit work even in low risk areas, in order to avoid PCAOB inspection findings.

I appreciate hearing critical comments and believe it is important that we continue our dialog with financial statement preparers. We take seriously concerns about inefficiencies and adverse consequences on companies, and we will continue to work toward the right balance between regulations intended to enhance investor protection and unnecessary burdens on auditors and issuers. For that reason, the PCAOB staff and Board take great care to ensure that inspection reports reflect only deficiencies based on existing risk based audit requirements, adopted by the Board after extensive consideration and public input. It is not our intention to impose new requirements through inspections. I find that, often, an open dialog between the PCAOB and an audit committee or management of a public company can provide context that helps all involved understand better why inspection findings are made and how the PCAOB expects firms to respond. To the extent we learn that auditors go to unreasonable extremes by conducting audits in a way that drives up costs without providing benefits, we want to hear about it so that we can consider an appropriate response.

Another way in which we are trying to ensure that our regulatory activities are well balanced is the Board's commitment to conducting economic analyses in connection with all of our auditing standard setting projects. The Board has hired several experienced economists to assist us in that effort, who are working closely with experienced accountants on our staff to enhance our collective understanding of economic concepts and how they relate to auditing. In recent standard setting projects, we have begun to gather information relating to costs and benefits of any new requirements under consideration, and we continue the learning process of both understanding and better articulating the potential costs and benefits of our work. Doing so requires input from our stakeholders, who can help us understand not just anticipated costs and benefits of new auditor requirements but also potentially less obvious unintended consequences. This is a work in progress, and we value feedback on how we are doing.

**Progress**

Shifting gears slightly, I would like to spend my remaining time talking about the state of auditor independence and audit quality now, more than a decade after the passage of the Sarbanes-Oxley Act and after extensive work by the PCAOB, SEC, audit committees, and auditors themselves.

Our inspection reports of the largest firms continue to include a high number of inspection findings, and, in at some firms, the number of findings has been increasing in recent years. This is of great concern to the Board, and we are working closely with firms to continue to drive improvements. It should also be said, however, that the nature of findings has
changed over time. Early on during our inspection process, our inspectors were finding deficiencies in a wide variety of audit areas, including in what I call basic "blocking and tackling" procedures. Today, the findings are narrower and more likely to occur in especially complex and subjective auditing areas, including internal controls, revenue recognition, accounting estimates and fair value. And even within these areas, findings have become more nuanced, such as in the area of internal controls, where we are seeing better compliance overall with applicable standards but finding deficiencies when we look deeper at whether auditors fully understand and appropriately test certain types of controls. So while a lot of work remains to be done, I am encouraged by the progress many auditors are making.

Other evidence, including the number and significance of restatements of public company financial statements, suggests that accounting and auditing have improved. A recent report by Audit Analytics indicates a leveling off in recent years in the number of public company restatements, along with a trend of restatements becoming less significant. There have been decreases in the average amount of income affected by the restatements, the average effect on earnings, the average length of the restatement periods, and the number of issues identified. While the results are a bit more mixed for accelerated filers, where so-called "revision restatements" have increased (though the significance of restatements even in this population continues to trend downward), I am encouraged that, overall, financial reporting appears to be improving.

While I firmly believe that PCAOB inspections, standard setting and enforcement activities have had a substantial, positive impact on audit quality, it is difficult to provide more specific measures to back up that claim. In addition to restatement data and PCAOB inspection findings, people have tried to look at litigation against auditors, investor and audit committee satisfaction, and industry peer reviews, to name just a few examples of possible ways to gauge audit quality. Because we believe it is important to gain more insight into this difficult area, and to provide audit committees and investors with better information to evaluate and oversee their auditors, our Office of Research and Analysis has been working over the last year on trying to identify a list of quantitative audit quality indicators. We hope that these indicators will provide additional information about whether particular audits are conducted by the right people, with the right tools, experience and resources, and have the right results. The indicators will not result in a comprehensive firm-wide scorecard or provide an easy answer for audit committees about which auditor or partner to engage, but we believe that they may provide some benchmarks for comparison and a basis for more informed discussion with auditors. The Board plans to issue a concept release describing our work in this area, and I encourage you to review it and provide us with your comments.

Another important aspect of trying to determine what drives audit quality is understanding what auditor actions or behaviors result in poor audits, and what auditors do that has positive results. Consistent with the requirement in the Sarbanes-Oxley Act that PCAOB inspections "assess the degree of compliance of each . . . firm . . . with th[e] Act, the rules of the Board, the rules of the Commission, or professional standards," our inspectors specifically look for and communicate audit deficiencies. PCAOB inspection reports are not intended to convey a balanced view of the strengths and weaknesses of each inspected firm. We do not provide grades to firms, and what we report should not be the only fact informing anyone's view about audit quality.
Nevertheless, we are frequently asked whether and how we can communicate what we observed in inspections of audits where we found no deficiencies. Said another way, where did things go right and why? In any given firm, PCAOB inspectors may find very different results in different audits of similar companies. Although our resources are limited, we are beginning to look more carefully at this question in the context of our inspections, including by conducting root cause analysis of good audits, not just those with deficiencies, and some of this work is feeding into our audit quality indicator project. I am encouraged that this work, along with our work on audit quality indicators, should provide more concrete information to investors, audit committees and others to aid in their evaluations of audit performance and, by extension, the work of the PCAOB.

With that, I will thank you for your attention thus far, and I look forward to the upcoming panel discussion and any questions that you may have.


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Audit Committee Dialogue

The PCAOB and audit committees share a common interest in audit quality. In our talks with audit committee members, we heard your request to provide insights from our oversight activities.

As a result of regularly inspecting more than 650 audit firms, including annually inspecting the largest firms, we are in a unique position to develop insights that may be helpful to audit committee members in your ongoing dialogue with and oversight of their auditors.

Our inspectors have recently embarked on our 2015 inspections. As they do each year, they have been considering two broad questions: What recurring audit concerns identified in past inspections are expected to continue to be significant? And what emerging audit risks might require increased focus by auditors and audit committees in the future?

Audit committees have a range of important responsibilities, and we know your time is at a premium. We highlight here key areas of recurring concern in our inspections of large firms and certain emerging risks that we see. Although our inspections take place only after audits are complete, we hope these insights will be useful to audit committees in your 2015 oversight activities. You may also find these insights useful in your interactions with management. We look forward to continuing our conversation, as you are key stakeholders in strengthening audit quality.

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Key Recurring Areas of Concern

In recent years, our inspections of member firms of six large global networks have frequently found significant deficiencies in the following areas that may be of concern to audit committees:

- Auditing internal control over financial reporting (ICFR)
- Assessing and responding to risks of material misstatement
- Auditing accounting estimates, including fair value measurements
- In cross-border audits, deficient “referred” work — work performed by other audit firms and used by the signing audit firm

Each of these areas is discussed briefly below.

1. The compiled inspection results presented in this document relate to information included in publicly available PCAOB inspection reports on member firms of the six global networks that include large U.S. firms and the largest number of PCAOB-registered non-U.S. firms: BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative, and PricewaterhouseCoopers International Limited.
1. Auditing internal control over financial reporting

Effective internal control over financial reporting can help to prevent material misstatements and the need for costly restatements. Properly executed, an audit of ICFR could help inform the audit committee of material weaknesses and may also identify other significant deficiencies in ICFR, so that they can be addressed. Indeed, promoting effective internal control may be one of the best ways an audit committee can help the company be prepared for both anticipated and unanticipated opportunities or challenges.

High quality audits of ICFR should provide audit committees important information about the condition of a company’s ICFR and the risk of future financial reporting problems. A properly executed audit of ICFR should identify an existing material weakness even if it has not yet resulted in a material misstatement.

Our inspections find a high rate of deficiencies in audits of ICFR. We often find that the auditor did not perform sufficient procedures to test the effectiveness of controls. In cases where auditors have identified deficiencies in controls, we sometimes find that the auditor did not sufficiently evaluate whether the identified deficiencies constituted material weaknesses. We are encouraged by recent improvements in this area at some firms, but continue to find a high rate of deficiencies at other firms.

Audits of ICFR don’t achieve their objectives if material weaknesses remain undetected until a material misstatement occurs and highlights it. Independent of our inspection observations, Audit Analytics has compiled data from SEC filings that suggest something about the frequency with which that occurs:

- 77 percent of the audit opinions issued in the last two completed reporting years (2012 and 2013) that stated that a material weakness in ICFR had been identified were issued either after, or in connection with, the issuer’s disclosure of a related financial reporting error that the issuer addressed through a restatement or an adjustment, including cases in which the error came to the attention of the issuer from outside of the financial reporting process, such as through regulatory investigations and whistleblower activity.2
- In 83 percent of the restatements announced during 2013 and 2014 by companies required to report on ICFR, no material weakness was reported in the ICFR opinion preceding the announcement.3

2. This figure is based on a review of Audit Analytics® data to identify ICFR audit opinions that identified material weaknesses and a review of the relevant companies’ SEC filings.
3. This figure is based on the number of restatements announced in a Form 8-K or a Form 6-K and a review of the most recent preceding ICFR audit opinions for those companies.
Potential Questions for Your Auditor

• What are the points within the company’s critical systems processes where material misstatements could occur? How has the audit plan addressed the risks of material misstatement at those points? How will your auditor determine whether controls over those points operate at a level of precision that would prevent or detect and correct a potential material misstatement?

• What is your auditor’s approach to evaluating the company’s controls over financial reporting for significant unusual transactions or events, such as the acquisition of assets and assumption of liabilities in a business combination, divestitures, and major litigation claims?

• If the company enters into a significant unusual transaction during the year, how will your auditor adjust the audit plan, including the plan for testing ICFR related to the transaction? For example, how would the company’s acquisition of a significant enterprise during the third quarter affect the audit plan for the year? How might your auditor’s materiality assumptions change? Would the audit plan focus on different systems and controls than originally planned? How would your auditor test controls over the systems used to generate information for recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree? How would the internal control over financial reporting of the acquired company be considered? Asking about the effectiveness of controls before such transactions and events occur will signal to your auditor that preparedness is a priority, as will asking similar questions about new systems and processes.

• If the company or your auditor has identified a potential material weakness or significant deficiency in internal control, what has been done to probe the accuracy of its description? Could the identified control deficiency be broader than initially described? Could it be an indication of a deficiency in another component of internal control?
2. Assessing and responding to risks of material misstatement

Assessing and responding to risks of material misstatement are critical activities in an audit. Many auditors do an effective job. But some auditors do not always identify the risks they should identify or respond effectively to existing risks that they have identified. This is particularly true with respect to auditing revenue, an area that often involves significant risks, including fraud risks.

We have the following insights to offer from our experience evaluating deficiencies in auditors’ responses to assessed risks:

• When risks change, audit plans should as well. A transaction or location that wasn’t material in the past may now be (or vice versa). Your auditor should conduct a rigorous analysis of changes in the company’s business and its environment as part of its risk assessment process and then be able to describe to you how this year’s audit plan addresses those changes.

• In integrated audits of large companies, PCAOB inspectors have seen audit plans that provide for insufficient audit procedures at certain locations or business segments that are significant contributors to the results of operations and involve higher risk of material misstatement of the financial statements. The explanation for this is usually that the auditor relied on entity-level controls to cover those locations or businesses. To employ that approach, it is important that auditors test those entity-level controls, along with controls over the related data used, and evaluate whether the controls are precise enough to address the relevant risks. Some auditors also assume that controls are uniform across locations, without a basis for such a conclusion, which may also lead to insufficient audit work.
Potential Questions for Your Auditor

• Which audit areas are designated by your auditor as having significant risks of material misstatement and what audit procedures are planned to address those risks?

• In your auditor’s view, how have the areas of significant risk of material misstatement changed since the prior year? What new risks has your auditor identified? What is your auditor’s process to make sure that it identifies new or changing risks of material misstatement and tailors the audit plan appropriately? How is the engagement partner involved?

• How does your auditor’s audit plan address the varied risks in a multi-location environment? If your auditor assumes that controls are uniform across multiple locations, how does your auditor support that assumption?

• If the company has operations in countries that are experiencing political instability, how has your auditor identified and addressed the specific risks that might result from such a circumstance? Or, if some of the company’s products are approaching technological obsolescence due to competitive new products, you might ask how your auditor plans to address the risks of inventory obsolescence.
3. Auditing estimates, including fair value measurements, and disclosures

Accounting estimates warrant significant audit attention because they involve subjective factors and judgments, which make them susceptible to management bias and material misstatement.

Inspectors have identified a large number of significant deficiencies in the auditing of accounting estimates over many years in areas such as revenue, allowances for loan losses, inventory reserves, fair value measurements, and tax-related estimates. Auditors also need to pay close attention to the identification and evaluation of indicators of asset impairments, particularly when economic conditions deteriorate.

Fortunately, inspectors have seen positive remedial steps in this area. Nevertheless, inspectors continue to see significant deficiencies, including auditors’ testing of related controls. Inspectors also continue to identify audit deficiencies when auditors have not sufficiently evaluated available information that appeared to be contrary to the information management used to support its estimates, including, for example, cash flow forecasts used in the budgeting process that differ from those used to determine the fair value of intangible assets for purposes of assessing whether those intangible assets or goodwill is impaired.
Potential Questions for Your Auditor

• What does your auditor do to obtain a thorough understanding of the assumptions and methods the company used to develop critical estimates, including fair value measurements?

• What is your auditor’s approach to auditing critical accounting estimates, such as allowances for loan losses, inventory reserves, and tax-related estimates?

• How has your auditor assessed whether management has identified all separable intangible assets that, while not included in the financial statements, must nevertheless be valued in connection with assessing goodwill for possible impairment (e.g., customer-related intangibles and in-process research and development)? Has your auditor considered contrary information that suggests the existence of such assets that management has not identified?

• Will your engagement team use its firm’s in-house valuation specialists? If so, how are the specialists integrated into the engagement team? How are specialists supervised, and how are significant issues they identify resolved? If the firm does not have in-house valuation specialists, does the firm engage external specialists to assist the auditor with their audit of complex estimates?
4. Referred work in cross-border audits

When auditing a multi-national company, the signing (or principal) auditor usually refers portions of the audit work (so-called “referred work”) to other firms, which are usually affiliated firms, that are located in the foreign countries where the company has operations. In such cases, the quality of the referred work can be critical to determining whether the financial statements are free of material misstatement and, if required, whether the company’s internal control over financial reporting is effective.

The PCAOB has inspected audit firms in 45 non-U.S. jurisdictions. In addition to examining work performed by these firms as the signing auditor for SEC reporting issuers located in their jurisdiction, our inspectors examine referred work performed by these firms. At some of these firms, the referred work is a significant part of their practice related to issuers.

In 2013, inspectors found significant problems in more than 40 percent of the referred-work engagements they inspected at non-U.S. member firms of the six networks mentioned above. Although the results of some 2014 inspections are still being evaluated, the 2014 inspections continued to identify deficiencies in referred-work engagements. These deficiencies showed up in the testing of such critical areas as revenue, inventory, and controls — frequently in circumstances where the revenue, inventory, or controls in question were significant to the issuer’s consolidated financial statements or the issuer’s overall ICFR, and the results reported by the other auditor formed part of the basis for the signing firm’s opinion.

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Potential Questions for Your Auditor

- How does the engagement partner assess the quality of the audit work performed in other jurisdictions? Were the firms that participate in the audit recently inspected by the PCAOB? If yes, what does the engagement partner know about the results?

- How does your auditor review the work? Does your auditor visit other countries to review the audit work done there? What steps does your auditor take to make sure that the work is performed by persons who understand PCAOB standards and U.S. GAAP and financial reporting requirements?

- As part of planning the audit, does your auditor consider performing additional steps if the referred work is in an area that has recently been the subject of a significant number of PCAOB inspection findings on your auditor?
New Risks the PCAOB is Monitoring

The landscape for public companies is constantly changing, and our inspectors take this into consideration when planning the year’s audit inspections.

In addition to considering risks based on recurring areas of audit deficiencies, such as those discussed above, we also consider indicators of potential emerging areas of audit risk. Here are some of the indicators of potential emerging risks that are informing our inspection planning for this year:

**Increase in mergers & acquisitions**

High cash levels, low interest rates, and shareholder pressure for growth have stimulated a level of merger and acquisition activity not seen for some time. More experienced members of the engagement team usually handle audit procedures for business combinations, yet problems still arise. In addition, while the revised business combination accounting standards have been in place for more than five years, even senior members of the audit team may lack sufficient experience in this area due to the relatively low level of merger and acquisition activity until recently. Inexperience may lead to the auditor failing to detect material misstatements in the accounting for a business combination.

PCAOB inspectors have observed a range of deficiencies related to auditing business combinations. For example, in some cases, auditors have relied on controls without testing them. Inspectors have also observed auditors failing to test company-produced data that are used to prepare cash flow projections to support fair value measurements. In other cases, auditors have failed to detect that management had not identified all the intangible assets that needed to be valued, such as customer-related intangible assets.

**Potential Questions for Your Auditor**

- Does your auditor have the expertise necessary to address the audit issues that may arise from the reporting requirements related to business combinations as well as other effects of a business combination that may bear on financial reporting, such as the effects on segment reporting? If not, how will your auditor obtain or develop that expertise?
Falling oil prices

The decline in oil prices in the past year raises a variety of audit issues. PCAOB inspectors plan to examine how auditors approach the risks of material misstatement resulting from changes in oil prices. These risks are not solely applicable to companies in the oil and gas industry, but also to other companies, regardless of whether they are directly or indirectly part of the supply chain to the oil and gas industry. Specific areas of focus include impairment and valuation issues and the collectability of loans and receivables.

Potential Questions for Your Auditor

• Have declining oil prices been identified as a risk factor and changed your auditor’s approach to testing related accounting estimates? Will your auditor require different evidence to support any assumptions and estimation methods used by the company that may depend on a certain level of oil prices?

• How might the estimated effects of falling oil prices be factored into estimates of the company’s future undiscounted net cash inflows used in the assessments of possible impairments of long-lived assets? How might those effects affect the possible need for recording or adjusting a deferred tax valuation account?

• Does the decline in oil prices create a need to disclose certain significant risks and uncertainties in the financial statements? Do oil price movements subsequent to year-end represent a subsequent event that requires disclosure in the company’s financial statements?
Undistributed foreign earnings

U.S. public companies collectively hold more than $2 trillion⁴ in undistributed foreign earnings that the managements of those companies assert will be indefinitely reinvested outside the U.S., thus avoiding financial reporting provisions for U.S. federal and state income taxes on such earnings. PCAOB inspectors have found problems in the auditing of management’s assertion, including the failure to evaluate the impact on that assertion of significant cash transfers from a foreign subsidiary to the U.S. parent. Inspectors have also seen problems in auditing controls over income tax accounting, generally, and related disclosures.

You should keep in mind that a conflict of interest between the company and your auditor could arise if the company faces legal liability or sanctions based on a tax strategy developed by your auditor. Such a conflict could affect your auditor’s ability to continue as the independent auditor, and the timing of such a change could be inconvenient. Audit committees may find it useful to keep a list of past tax strategy engagements and monitor the list for potential effects on the audit.

Potential Questions for Your Auditor

- What is the nature and extent of audit evidence gathered by your auditor related to management’s assertions about indefinite reinvestment? Is there contrary evidence? If so, how did your auditor consider the contrary evidence?

- Has your auditor considered whether the company’s MD&A disclosure, including disclosure regarding liquidity and capital resources, is consistent with, or contradicts, management’s indefinite reinvestment assertion?

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Maintaining audit quality while growing other business

Audit firms currently do significantly less non-audit work for issuer audit clients than they did prior to the turn of the century. Nevertheless, each of the largest firms continues to maintain non-audit services lines of business. Recently, several firms have acquired significant consulting firms to grow certain consulting services. Each of the Big Four firms, for example, has in recent years experienced an increase in the percentage of its revenue that comes from advisory services and a decrease in the percentage of its revenue that comes from assurance services.\(^5\)

Even when an audit firm does not provide significant non-audit services to a particular issuer audit client, we are concerned about the effects such business developments may have on the firm’s attention to audit quality. Depending upon how a firm manages that growth, there is a risk that the culture within a firm could tend to drift from a focus on audit quality to a focus that subordinates audit quality to other business opportunities and challenges. That would undermine the PCAOB’s and audit committees’ interest in high quality audits.

Potential Questions for Your Auditor

- Has your engagement team been affected by any changes in the firm’s business model? Has the engagement team lost key auditors or specialists to other lines of business? How are you ensuring that the quality of the audit team will remain high over time?

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\(^5\) Source: Transparency reports issued by Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP for years 2011 to 2014.
Keep This Dialogue Going

Tap into more PCAOB insights

If you would like to receive future PCAOB updates on other topics and/or specific ones targeted to audit committee members, please sign up on our website.

If you would like to contact us, please send us a message on our website.
STAFF AUDIT PRACTICE ALERT NO. 11

CONSIDERATIONS FOR
AUDITS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

October 24, 2013

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Summary

The Office of the Chief Auditor is issuing this practice alert in light of significant auditing practice issues observed by the Public Company Accounting Oversight Board ("PCAOB" or the "Board") staff in the past three years relating to audits of internal control over financial reporting ("audits of internal control"). The practice alert highlights certain requirements of the auditing standards of the PCAOB in aspects of audits of internal control in which significant auditing deficiencies have been cited frequently in PCAOB inspection reports. Specifically, this alert discusses the following topics:

- Risk assessment and the audit of internal control
- Selecting controls to test
- Testing management review controls
- Information technology ("IT") considerations, including system-generated data and reports
- Roll-forward of controls tested at an interim date
- Using the work of others
Evaluating identified control deficiencies

Auditors should take note of the matters discussed in this alert in planning and performing their audits of internal control. Because of the nature and importance of the matters covered in this alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews. Auditing firms also should consider whether additional training of their auditing personnel is needed for the topics discussed in this alert.

Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditors' internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings, and ask how they are addressing the matters discussed in this alert. In particular, audit committees may want to inquire about the involvement and focus by senior members of the firm on these matters.
Introduction

Effective internal control over financial reporting ("internal control") helps assure that companies produce reliable published financial statements that investors can use in making investment decisions. Since the 1970s, federal laws have required public companies to maintain sufficient "internal accounting controls."\(^1\) The Sarbanes-Oxley Act of 2002, as amended, ("Act") requires company management to annually assess and report on the effectiveness of the company's internal control. For larger companies, the Act also requires independent auditors to attest to management's assessment of the effectiveness of the company's internal control.\(^2\)

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, establishes requirements for performing and reporting on audits of internal control. The audit of internal control should be integrated with the audit of the financial statements. The objectives of the audits are not identical, and the auditor must plan and perform the work to achieve the objectives of both audits. In reporting on an integrated audit of internal control and financial statements ("integrated audit"), the auditor expresses an opinion on the financial statements and an opinion on the effectiveness of the company's internal control.

\(^1\) See 15 U.S.C. 78m, which was added to federal securities law by the Foreign Corrupt Practices Act of 1977, which sets forth requirements for devising and maintaining a "system of internal accounting controls" sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria.

\(^2\) See § 404 of the Act. The auditor attestation requirement applies to companies that qualify as "large accelerated filers" or "accelerated filers," other than "emerging growth companies." Pursuant to 17 C.F.R. § 240.12b-2, the designation of accelerated filers and large accelerated filers is based on, among other things, the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates as of the last business day of the issuer's most recently completed second fiscal quarter. For an accelerated filer, the aggregate market value criterion is $75 million or more, but less than $700 million. For a large accelerated filer, the aggregate market value criterion is $700 million or more.
Auditing Standard No. 5 establishes a top-down, risk-based approach to the audit of internal control. The auditing standard is designed to focus auditors on the most important matters in the audit of internal control and avoid procedures that are unnecessary to an effective audit.

When Auditing Standard No. 5 was adopted, the Board announced its intention to monitor the implementation of that auditing standard. The PCAOB has continued to monitor Auditing Standard No. 5 execution as part of its ongoing oversight activities. Over the last three years, the PCAOB's inspections staff has observed a significant number of auditing deficiencies in audits of internal control. As reported in *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* ("the general inspection report"), in 46 of the 309 integrated audit engagements (or 15 percent) covered by the general inspection report, inspections staff found that the firm, at the time it issued its audit report, had failed to obtain sufficient appropriate evidence to support its opinion on the effectiveness of internal control due to one or more auditing deficiencies identified by the inspections staff. The general inspection report also noted that, in an additional 16 percent of the engagements covered by the report, the inspections staff identified other deficiencies in the auditing of internal control that did not involve findings of such significance that they indicated a failure to support the firm's internal control opinion. Inspections in subsequent years have

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3/ Under PCAOB standards, a top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion. See paragraph 21 of Auditing Standard No. 5.

continued to identify similarly high levels of deficiencies in audits of internal control.

Deficiencies in audits of internal control also can affect the audit of the financial statements. In integrated audits, auditors often rely on controls to reduce their substantive testing of financial statement accounts and disclosures. Thus, deficiencies in testing and evaluating internal control can lead to inadequate testing of accounts and disclosures in the financial statement audit. The general inspection report notes that, in 39 of the 46 engagements (85 percent) in which the inspection staff found that the firm did not have sufficient appropriate evidence to support the firm's internal control opinion, representing 13 percent of the 309 integrated audit engagements that were inspected, inspection staff found that the firm also failed to obtain sufficient appropriate evidence to support its opinion on the financial statements.

Significant auditing deficiencies in audits of internal control that have been frequently cited in PCAOB inspection reports include failures to:

- Identify and sufficiently test controls that are intended to address the risks of material misstatement;
- Sufficiently test the design and operating effectiveness of management review controls that are used to monitor the results of operations;
- Obtain sufficient evidence to update the results of testing of controls from an interim date to the company's year end (i.e., the roll-forward period);
- Sufficiently test controls over the system-generated data and reports that support important controls;\(^6\)

\(^5\) Although the general inspection report relates to inspections of eight domestic registered firms that have been inspected annually since the inception of the PCAOB inspections program, as the report states, PCAOB inspections have found similar problems with audits of internal control at other registered firms.

\(^6\) See paragraph 39 of Auditing Standard No. 5, which provides that the auditor should test those controls that are important to the auditor's
Sufficiently perform procedures regarding the use of the work of others; and

Sufficiently evaluate identified control deficiencies.\(^7\)

This practice alert discusses the application of certain requirements of Auditing Standard No. 5 and other PCAOB standards to specific aspects of the audit of internal control in light of recent observations of auditing deficiencies. Specifically, this alert discusses the following topics:

- **Risk assessment and the audit of internal control.** This alert explains how the risk assessment process set forth in PCAOB standards relates to certain aspects of the audit of internal control. It also discusses coordinating the procedures for obtaining an understanding of internal control with the Auditing Standard No. 5 objectives for understanding likely sources of misstatement, assessing risks for components of significant accounts and disclosures, and considering risk in determining the scope of testing in multi-location engagements.

- **Selecting controls to test.** The alert discusses the requirements for selecting controls to test and considerations for making an appropriate selection of controls to test, including controls that operate infrequently.

- **Testing management review controls.** The alert discusses management review controls and the requirements in PCAOB standards for testing those controls.

- **Information technology ("IT") considerations, including system-generated data and reports.** The alert highlights requirements in PCAOB standards regarding the consideration of IT in audits of internal control, including testing controls that use system-generated data and reports.

\(^7\) See, e.g., PCAOB Release 2012-006, Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting (December 10, 2012).
generated data and reports and evaluating deficiencies in IT general controls ("ITGCs").

- **Roll-forward of controls tested at an interim date.** The alert discusses the auditor’s responsibilities when controls are tested at an interim date in the audit of internal control, including the necessary roll-forward procedures to extend the results of interim testing to year end.

- **Using the work of others.** The alert discusses the requirements in PCAOB standards regarding when it is appropriate to use the work of others, how to determine the extent to which the work can be used, and the importance of testing the work of others.

- **Evaluating identified control deficiencies.** The alert discusses the auditor’s responsibilities for evaluating control deficiencies and highlights the importance of testing compensating controls and performing the evaluation with professional skepticism and careful analysis.

### Risk Assessment and the Audit of Internal Control

One of the potential root causes for the deficiencies in audits of internal control, as cited in the general inspection report, is improper application of the top-down approach set forth in PCAOB standards.\(^8\) For example, the general inspection report notes that, in some instances, it appears that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether they adequately addressed the assessed risks of material misstatement of the significant account or disclosure. In some instances, inspections staff observed that firms failed to test controls for all relevant assertions of the significant accounts and disclosures. In other instances, it appeared to the inspections staff that firms did not sufficiently understand the likely sources of

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\(^8\) See paragraph 21 of Auditing Standard No. 5. Also, the general inspection report notes that the improper application of the top-down approach may be caused, in part, by other root causes discussed in that report and a reduced focus by firms on the requirements of Auditing Standard No. 5. See the general inspection report at 18.
potential misstatements related to significant accounts or disclosures as part of selecting controls to test.

Risk assessment is a key element of the top-down approach, and it underlies the entire audit process in the audit of internal control.\footnote{See paragraph 10 of Auditing Standard No. 5. Also, see generally, Auditing Standard No. 8, \textit{Audit Risk}, Auditing Standard No.12, \textit{Identifying and Assessing Risks of Material Misstatement}, and Auditing Standard No. 13, \textit{The Auditor's Responses to the Risks of Material Misstatement.}} An effective risk assessment process pursuant to PCAOB standards is fundamental to the audit of internal control.\footnote{See paragraph 6 of Auditing Standard No. 12 and paragraphs 6 and 10 of Auditing Standard No. 5.} Identifying the risks of material misstatement – including the types of potential misstatements that can occur and the likely sources of those potential misstatements – is necessary for the auditor to select appropriate controls to test and to evaluate whether those controls adequately address the risks. For example, an auditor who identifies revenue overstatement as a risk, without assessing how overstatements might occur or understanding the controls in place to address the risk, lacks the basis to make an informed selection of controls to test or to meaningfully evaluate whether the selected controls are designed and operating to prevent or detect potential misstatements.

Auditing Standard No. 5 requires a risk-based audit approach. Proper application of the auditing standards for assessing and responding to risk ("risk assessment standards")\footnote{Auditing Standard Nos. 8-15.} is important for performing effective audits of internal control and integrating the audit of internal control with the audit of financial statements.

Auditing Standard No. 12, \textit{Identifying and Assessing Risks of Material Misstatement}, establishes a process for identifying and assessing risks of material misstatement in an audit, which applies to audits of internal control and audits of financial statements. The risk assessment procedures required by Auditing Standard No. 12 include, among other things, obtaining an understanding of the company and its environment and obtaining an understanding of internal control. The auditing standard also sets forth a process for assessing identified risks, which includes determining the likely sources of

\[9/\] An effective risk assessment process pursuant to PCAOB standards is fundamental to the audit of internal control.\footnote{See paragraph 10 of Auditing Standard No. 5. Also, see generally, Auditing Standard No. 8, \textit{Audit Risk}, Auditing Standard No.12, \textit{Identifying and Assessing Risks of Material Misstatement}, and Auditing Standard No. 13, \textit{The Auditor's Responses to the Risks of Material Misstatement.}} Identifying the risks of material misstatement – including the types of potential misstatements that can occur and the likely sources of those potential misstatements – is necessary for the auditor to select appropriate controls to test and to evaluate whether those controls adequately address the risks. For example, an auditor who identifies revenue overstatement as a risk, without assessing how overstatements might occur or understanding the controls in place to address the risk, lacks the basis to make an informed selection of controls to test or to meaningfully evaluate whether the selected controls are designed and operating to prevent or detect potential misstatements.

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potential misstatement and evaluating the types of misstatements that could result from the risks; the accounts, disclosures, and assertions that could be affected; and the likelihood and magnitude of potential misstatements.\(^{12}\)

**Obtaining an Understanding of Internal Control**

In an audit of internal control, a thorough understanding of the company's internal control is important because it enables the auditor to appropriately plan and perform the necessary tests of controls. Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component\(^{13}\) of internal control to (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design tests of controls and substantive procedures.\(^{14}\)

Understanding internal control includes understanding the information system, including the related business processes, relevant to financial reporting, which comprise the following:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

\(^{12}\) See paragraphs 59 and 61 of Auditing Standard No. 12.

\(^{13}\) Paragraph 21 of Auditing Standard No. 12 provides that internal control can be described as consisting of the following components: the control environment, company's risk assessment process, information and communication, control activities, and monitoring of controls.

\(^{14}\) See paragraph 18 of Auditing Standard No. 12 and paragraph 13 of Auditing Standard No. 15, *Audit Evidence*. 
d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements; and

e. The period-end financial reporting process.\textsuperscript{15/}

In an audit of internal control, Auditing Standard No. 5 requires the auditor to perform procedures to achieve certain objectives for further understanding likely sources of potential misstatements and as part of selecting controls to test.\textsuperscript{16/} The procedures performed to achieve those objectives may be performed concurrently with procedures for identifying and assessing risks of material misstatement pursuant to Auditing Standard No. 12. Performing the procedures concurrently could facilitate compliance with PCAOB standards, enhance the auditor's understanding of the company's processes and likely sources of potential misstatements, and avoid potential duplication of audit effort.

The following table illustrates how certain of the procedures required by Auditing Standard No. 12 can be coordinated with the procedures applied to meet certain of the Auditing Standard No. 5 objectives. For example, while obtaining an understanding of the information system pursuant to Auditing Standard No. 12, the auditor also can perform procedures to understand the flow of transactions for relevant assertions. Similarly, while obtaining an understanding of the company's risk assessment process and control activities, the auditor also can identify the controls that management has implemented to address potential misstatements.

\textsuperscript{15/} See paragraph 28 of Auditing Standard No. 12.

\textsuperscript{16/} See paragraph 34 of Auditing Standard No. 5.
<table>
<thead>
<tr>
<th>Procedures Required by Auditing Standard No. 12</th>
<th>Related Objective in Auditing Standard No. 5&lt;sup&gt;17/&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain an understanding of the information system, including the related business processes, relevant to financial reporting&lt;sup&gt;18/&lt;/sup&gt;</td>
<td>Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded</td>
</tr>
<tr>
<td>Identify and assess the risks of material misstatement at the assertion level and identify significant accounts and disclosures and their relevant assertions&lt;sup&gt;19/&lt;/sup&gt;</td>
<td>Verify that the auditor has identified the points within the company’s processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material</td>
</tr>
<tr>
<td>Obtain an understanding of the company’s risk assessment process and control activities,&lt;sup&gt;20/&lt;/sup&gt; and consider controls that address fraud risks and other significant risks&lt;sup&gt;21/&lt;/sup&gt;</td>
<td>Identify the controls that management has implemented to address the potential misstatements</td>
</tr>
<tr>
<td>Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could result in a material misstatement of the financial statements</td>
<td></td>
</tr>
</tbody>
</table>

<sup>17/</sup> Id.  
<sup>18/</sup> See paragraph 28 of Auditing Standard No. 12.  
<sup>19/</sup> See paragraphs 59-64 of Auditing Standard No. 12.  
<sup>20/</sup> See paragraphs 26-27 of Auditing Standard No. 12.  
<sup>21/</sup> See paragraph 34 of Auditing Standard No. 12.  
<sup>22/</sup> See paragraphs 72-73 of Auditing Standard No. 12.
Auditing Standard No. 5 and Auditing Standard No. 12 provide that, although walkthroughs are not required, performing walkthroughs that encompass the procedures set forth in the standard\textsuperscript{23/} is an effective way to meet the required Auditing Standard No. 5 objectives in the table above and may be used in testing the design of controls.\textsuperscript{24/} Thus, careful planning and execution of walkthroughs, particularly when performed or supervised by experienced personnel, can enhance the effectiveness of those aspects of the integrated audit and avoid duplication of effort. Incomplete or poorly executed walkthroughs, however, can lead to inadequate risk assessments, which can impair the effectiveness of auditors' selection and testing of controls.

The general inspection report notes that, in some situations, firms' walkthrough procedures were not adequate to verify the auditor's understanding of the risks in the company's processes and to identify and select for testing controls sufficient to address the risk of misstatement for the relevant assertions, as they were limited to:

- Performing inquiry and observation to confirm that there have been no significant changes to the processes;
- Obtaining an understanding through controls testing and substantive procedures;
- Reviewing walkthroughs performed by the company's internal auditor who did not provide direct assistance under the firm's supervision; or

\textsuperscript{23/} Paragraph 37 of Auditing Standard No. 5 provides that, in performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

\textsuperscript{24/} See paragraphs 37-38 and 43 of Auditing Standard No. 5, paragraphs 20 and 37-38 of Auditing Standard No. 12, and paragraph 20 of Auditing Standard No. 13.
Relying on the auditor’s knowledge and experience obtained from prior years’ audits.

Assessing Risks of Material Misstatement in Components of Significant Accounts and Disclosures

In assessing risks of material misstatement and selecting controls to test, it is important for auditors to be aware that the components of a potential significant account or disclosure might be subject to significantly different risks.\(^{25/}\) Also, different risks of material misstatement affecting the same assertion of an account or disclosure might arise at different points within the company’s processes. If risks differ among components, the auditor might need to select and test different controls to support a conclusion that the controls adequately address the risks to the account or disclosure.

The following are some examples of accounts and disclosures for which individual components could have different risks:

- Individual revenue categories might have different risks because of varying types of products and services, sales terms, information systems, including revenue processes, or accounting requirements.

- Individual investment securities or categories of securities in a portfolio might have different risks if they vary in nature and complexity, level of market activity, or availability of observable market data.

- The components of an allowance for loan losses might have different risks, for instance, if those components reflect different credit exposures, are determined using different methods, or are subject to different accounting requirements.

- The components of a reserve for sales returns and allowances might have different risks if they relate to different sales terms or repayment terms, use different information systems, including business processes, or are subject to different accounting requirements.

\(^{25/}\) See paragraph 63 of Auditing Standard No. 12.
Effect of Risk Assessment on the Scope of Testing in Multi-location Engagements

Inspections staff have observed instances, such as the following, in which it appeared that firms did not sufficiently test controls that addressed the risks of material misstatement in multi-location engagements:

- Testing a sample of locations and extrapolating the results of that testing to other locations without performing procedures to evaluate whether the issuers’ systems and controls were designed and implemented consistently across all of those locations.

- Excluding certain locations from testing without establishing whether there was a reasonable basis for excluding those locations.

Also, inspections staff have observed instances in which it appeared that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether the controls selected for testing, individually or in combination, adequately addressed the assessed risks of material misstatement of the significant account or disclosure across the significant locations.

In multi-location engagements, PCAOB standards require the auditor to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of auditing attention devoted to the location or business unit with the degree of risk. Auditing Standard No. 9 lists factors that are relevant to the assessment of the risk of material misstatement associated with a location or business unit and the determination of the necessary audit procedures. Certain of the factors listed in Auditing Standard No. 9 relate to the inherent risks of material misstatement, while others – such as the control environment, centralized processing, and monitoring activities – relate to entity-level controls. Auditing Standard No. 5 provides that, in lower risk locations, the auditor might first evaluate whether entity-level controls, including controls in place to provide

\[26/\] See paragraph 11 of Auditing Standard No. 9, *Audit Planning*, and paragraph B10 of Auditing Standard No. 5.

\[27/\] See paragraph 12 of Auditing Standard No. 9.
assurance that appropriate controls exist throughout the organization, provide the auditor with sufficient evidence.\textsuperscript{28/} Auditing Standard No. 5 also provides that the auditor may take into account the work of others in determining the locations or business units at which to perform tests of controls.\textsuperscript{29/} Using the work of others is discussed later in this alert.

To illustrate the application of these principles, assume that an auditor is performing an integrated audit of a company with business units in several locations. After assessing the risks associated with the individual locations, an auditor might design an audit strategy involving:

a. Identifying and testing controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements;

b. To the extent not covered in item a above, identifying and testing controls at locations or business units that, individually or in combination, present a reasonable possibility of material misstatement through one or more of the following:

   (1) Testing entity-level controls that operate at a level of precision that would detect material misstatements in the locations or business units, individually or in combination.

   (2) For locations with centralized systems and processes and homogeneous controls, performing tests of the common controls across the locations or business units.

   (3) Using the work of others who tested controls at the locations, to the extent appropriate, as discussed later in this release.

c. No specific testing of controls for locations or business units that individually or in combination do not present a reasonable possibility of material misstatement of the consolidated financial statements.

\textsuperscript{28/} See paragraph B11 of Auditing Standard No. 5.

\textsuperscript{29/} See paragraph B12 of Auditing Standard No. 5.
In testing controls at locations or business units other than controls that address specific risks, the auditor should reassess the audit strategy if the auditor obtains information that is contrary to the premises under which the audit strategy was developed. For example, the strategy should be reassessed if the auditor obtains information indicating certain locations have risks not identified previously; certain locations have higher risk than the initial assessment; certain locations do not have homogeneous processes, systems, controls, or operating environments as previously thought; entity-level controls do not, by themselves, operate with the necessary level of precision; or the work of others cannot be used to the extent planned.

Selecting Controls to Test

As discussed previously, the general inspection report notes that, in some instances, it appears that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether they adequately addressed the assessed risks of material misstatement of the significant account or disclosure. In some instances, inspections staff observed that firms failed to test controls for all the relevant assertions of the significant accounts and disclosures.

In the audit of internal control, PCAOB standards require the auditor to test:

a. Entity-level controls that are important to the auditor’s conclusion about whether the company has effective internal control over financial reporting, including evaluating the control environment and period-end financial reporting process; and

\[30/\] See paragraph 15 of Auditing Standard No. 9 and paragraph 74 of Auditing Standard No. 12, which discuss the auditor’s responsibilities for changing the audit strategy and planned audit procedures when circumstances change or contrary information is identified.

\[31/\] Paragraph 14 of Auditing Standard No. 5 provides that the auditor also should evaluate whether the company’s controls sufficiently address identified fraud risks and controls intended to address the risk of management override.

\[32/\] See paragraphs 22 and 26 of Auditing Standard No. 5.
b. Controls that are important to the auditor’s conclusion about whether the company’s controls sufficiently address the assessed risk of misstatement to each relevant assertion (which may be entity-level controls or other controls). 33/

Also, Auditing Standard No. 5 cautions that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures. 34/

In selecting controls over significant accounts and disclosures, an important consideration is determining that the auditor has selected controls that, individually or in combination, are intended to address the identified risks of material misstatement, including risks for the relevant assertions and the components of the account or disclosure with differing risks. The following is a partial list from the general inspection report of assertions or account components for which inspections staff observed that auditors failed to identify and sufficiently test controls that addressed the risks of material misstatement:

- Revenue: Significant business units or significant revenue categories, significant contract provisions affecting revenue recognition, and significant inputs to percentage-of-completion calculations
- Inventory: Pricing of significant inventory components and determination of reserves for excess and obsolete inventory
- Fair value of financial instruments: Inputs used to value hard-to-value financial instruments and determinations of the classification of securities within the fair value hierarchy set forth in Financial Accounting Standards Board Accounting Standards Codification Topic 820, Fair Value Measurement
- Valuation of pension plan assets 35/

33/ See paragraphs 23, 39, and 41 of Auditing Standard No. 5.

34/ See paragraph B9 of Auditing Standard No. 5.

35/ See the general inspection report at 5-6.
To illustrate the process of selecting controls to test, assume that an auditor identifies risks of material misstatement related to reserves for excess and obsolete inventory. When selecting controls that are important to address the risks of material misstatement, it is important to look for controls that encompass each segment of inventory for which there is a reasonable possibility of material misstatement regarding the related reserve for excess and obsolete inventory. Limiting the selection to controls over inventory segments that have no reserves, for example, would not be sufficient to address the risk of material misstatement.

The procedures performed to obtain an understanding of internal control pursuant to Auditing Standard No. 12 and to meet the objectives of paragraph 34 of Auditing Standard No. 5 can provide a basis for the auditor to determine whether the selected controls cover the identified risks. For example, performing those procedures enables the auditor to understand the likely sources of potential misstatement and the controls intended to prevent or detect those misstatements.

Another important consideration in selecting controls to test is whether the controls, individually or in combination, are capable of addressing the risks of material misstatement to the relevant assertion. Some risks, especially those related to complex processes or subjective estimates, might require a combination of controls to prevent or detect misstatements. For example, if a company has a complex income tax calculation, the controls needed to address the risks of material misstatement might consist of a combination of (1) a review of the overall tax calculation by a person with the necessary authority and competence and (2) certain other types of controls over key aspects of the calculation. As another example, an auditor might select a combination of a manual review control that uses system-generated data and IT controls over the completeness and accuracy of that data, as discussed later in this alert.

Controls over Infrequent Processes and Transactions

Internal control is not limited to frequent processes and normal recurring transactions. It also applies to infrequent processes, such as an analysis of whether long-term assets are impaired, and to nonrecurring transactions outside the normal course of business, such as a material business combination.

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36/ See paragraphs 23, 39, and 41 of Auditing Standard No. 5.
When a company has infrequent processes or enters into nonrecurring transactions that present a reasonable possibility of material misstatement of the financial statements, the auditor should test the controls over those processes or transactions. Performing substantive audit procedures to determine whether the accounts or transactions are accounted for properly is important for the financial statement audit but, by itself, does not provide sufficient appropriate evidence to support a conclusion that the controls over those transactions or analyses are designed and operating effectively. As discussed previously, Auditing Standard No. 5 cautions that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures.37/

In some cases, auditors are able to design and perform procedures that test controls over nonrecurring transactions concurrently with substantive tests of those transactions, thereby obtaining sufficient appropriate evidence to fulfill the related objectives for the financial statement audit and the audit of internal control. For example, when auditing the company's accounting for a business combination, the auditor also might obtain an understanding of the company's financial reporting process, and related controls, regarding the business combination. In that situation, the auditor could test important controls over the accounting for business combinations when auditing the accounting for the business combination. In that situation, the auditor's substantive testing and tests of controls should be sufficient to meet the objectives of both tests.

**Testing Management Review Controls**

Auditors often select and test management review controls in audits of internal control. Such management reviews might be performed to monitor the results of operations, such as (1) monthly comparisons of actual results to forecasted revenues or budgeted expenses; (2) comparisons of other metrics, such as gross profit margins and expenses as a percentage of sales; and (3) quarterly balance sheet reviews. These reviews typically involve comparing recorded financial statement amounts to expected amounts and investigating significant differences from expectations.

As with other types of controls, the auditor should perform procedures to obtain evidence about how a management review control is designed and

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37/ See paragraph B9 of Auditing Standard No. 5.
operates to prevent or detect misstatements.\(^{38}\) Verifying that a review was signed off provides little or no evidence by itself about the control's effectiveness.

**Evaluating the Precision of Management Review Controls**

Many management review controls are entity-level controls, so testing those review controls can be an appropriate part of a top-down approach. Auditing Standard No. 5 provides that entity-level controls vary in nature and precision and that some entity-level controls might operate at a level of precision that would adequately prevent or detect misstatements on a timely basis.\(^ {39}\) Other entity-level controls, by themselves, might not operate with the necessary level of precision, but might be effective in combination with other controls in addressing the assessed risk of material misstatement.

Thus, the main consideration in assessing the level of precision is whether the control is designed and operating to prevent or detect on a timely basis misstatements that could cause the financial statements to be materially misstated. Factors that can affect the level of precision of an entity-level control include the following:

- **Objective of the review.** A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.

- **Level of aggregation.** A control that is performed at a more granular level generally is more precise than one performed at a higher level. For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.

- **Consistency of performance.** A control that is performed routinely and consistently generally is more precise than one performed sporadically.

\(^{38}\) See paragraphs 42-45 of Auditing Standard No. 5, which describe the auditor's responsibilities for testing the design and operating effectiveness of controls.

\(^{39}\) See paragraph 23 of Auditing Standard No. 5.
Correlation to relevant assertions. A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion. For example, a control designed to detect errors in the recorded amounts of accounts receivable might not operate with a sufficient level of precision to detect errors in the valuation of delinquent receivables.

Predictability of expectations. Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts ("detective controls"). The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.

Criteria for investigation. For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.

Testing Design Effectiveness

Auditing Standard No. 5 provides that the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatement of the financial statements.

Evaluating whether a management review control is capable of preventing or detecting potential material misstatements generally involves obtaining an understanding of and evaluating the following:

40/ See paragraph A2 of Auditing Standard No. 5 for the definition of the term "control objective."

41/ See paragraph 42 of Auditing Standard No. 5.
a. Whether the control satisfies the corresponding control objective, including whether it addresses the risks of material misstatement to the relevant assertion of the significant account or disclosure;

b. The factors affecting the precision of the review, including the objective of the review and the appropriateness of the expectations, level of aggregation, and criteria for investigation for identifying potentially material misstatements;

c. The steps involved in identifying, investigating, and resolving significant differences from expectations;

d. The person(s) who performs the control, including the competence and authority of the person(s);

e. The frequency of performance of the control, that is, whether the review occurs often enough to prevent or detect misstatements before they have a material effect on the financial statements; and

f. The information used in the review, for example, whether the review uses system-generated data or reports, as discussed later in this alert.

The evaluation of design may be performed in conjunction with obtaining an understanding of internal control over financial reporting and performing procedures to achieve the objectives of paragraph 34 of Auditing Standard No. 5, which were presented in the prior table.\footnote{42} For example, to assess whether a control is effectively designed, it is important to identify the risk of material misstatement to the relevant assertion of the significant account or disclosure that the control is intended to address.

\footnote{42} See paragraph 43 of Auditing Standard No. 5, which provides that procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.
Testing Operating Effectiveness

Auditing Standard No. 5 provides that the auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control has the necessary authority and competence to perform the control effectively.\textsuperscript{43/} The auditing standard also provides that the evidence necessary to persuade the auditor that a control is effective depends upon the risk associated with the control.\textsuperscript{44/}

Testing the operating effectiveness of a management review control involves performing procedures to evaluate whether the control is working as designed to prevent or detect potentially material misstatements. Testing typically involves, for selected operations of the control, obtaining and evaluating evidence about:\textsuperscript{45/}

\begin{enumerate}
  \item The steps performed to identify and investigate significant differences; and
  \item The conclusions reached in the reviewer's investigation, including whether potential misstatements were appropriately investigated and whether corrective actions were taken as needed.
\end{enumerate}

The nature, timing, and extent of testing should be commensurate with the risk associated with the controls. Higher risk controls warrant more testing.

The auditor also should take into account other relevant evidence obtained in the audit when evaluating the effectiveness of a control, such as identified misstatements that were not prevented or detected by the control.\textsuperscript{46/}

\footnotesize
\textsuperscript{43/} See paragraph 44 of Auditing Standard No. 5.
\textsuperscript{44/} See paragraph 46 of Auditing Standard No. 5.
\textsuperscript{45/} If the control uses system-generated information or reports, the auditor also should obtain evidence about the completeness and accuracy of those reports, as discussed in the information technology considerations section of this alert. This also applies to other internally-produced information used by the company in an important control.
\textsuperscript{46/} See paragraph 71 of Auditing Standard No. 5.
Example: Test of a Management Review Control

To illustrate the process of testing management review controls, assume that, in an audit of a commercial enterprise with four similar branch locations, the auditor selects for testing a monthly control over the existence, completeness, and allocation assertions for certain selling, general, and administrative expenses, such as salaries and wages, utilities, facilities, and depreciation. In the selected control, each branch controller performs an analysis comparing the expense-related accounts in the branch's financial statements to the prior year and forecasted financial statements for the branch and investigates differences over a predetermined threshold set by the company's chief financial officer ("CFO"). Each branch controller discusses the results of the analysis with the CFO to enable the CFO to understand the basis for significant differences and determine whether any financial statement adjustments or other corrective actions are needed.

The auditor assesses a higher risk associated with the management review control because the control applies to multiple assertions for several material accounts with varying levels of risk of material misstatement.47/

In this illustration, the auditor's procedures may include the following:48/

a. Evaluating whether the control addresses the risks of material misstatement to the relevant assertions of the selling, general, and administrative expense accounts, as intended;

b. Evaluating whether the use of prior year and forecast information at the branch level is an appropriate basis for establishing expectations to identify potential misstatements;

47/ See, e.g., paragraph 47 of Auditing Standard No. 5, which provides that two factors affecting the risk associated with a control are (1) the nature and materiality of misstatements that the control is intended to prevent or detect and (2) the inherent risk associated with the related account(s) and assertion(s).

48/ The procedures listed here are illustrative. The actual procedures needed for a particular management review control will depend on, among other things, the nature of the control, the risk associated with the control, the information used in the control, and the evidence of the control's operation.
c. Evaluating whether the criteria used for identifying differences for investigation are set at an appropriate level to enable the branch controller to identify misstatements that could be material to the financial statements, individually or in combination with other misstatements;

d. Evaluating the competencies of the CFO and branch controllers based on, among other things, the auditor's knowledge of the individuals and experience with them in current and prior audits;

e. Evaluating whether the control operates often enough to prevent or detect misstatements before they have a material effect on the financial statements;

f. For selected operations of the control, obtaining the information used by the branch controller in the analysis, understanding the steps performed by the branch controller to investigate significant differences, reperforming the analysis and comparing the auditor's identification of significant differences and evaluation of results – including identified misstatements, if any – to the branch controller's analysis; and

g. Observing or reading summaries of selected meetings in which the results of the analyses by the branch controllers were discussed with the CFO; inspecting the information presented to the CFO; and evaluating the matters discussed, conclusions reached, and corrective actions taken, if any.

The auditor also determined that the control uses financial statement and forecast information that is maintained and reported by the same IT system. The company's IT systems are centrally managed, and the IT controls for that system were tested in conjunction with tests of IT controls for the company's other financial statement related systems.

The preceding example illustrates an approach to testing accounts that tend to be routine and predictable. If testing controls over accounts or assertions that are more complex or less predictable, management review controls consisting primarily of comparisons to budgets or forecasts might not operate at a sufficient level of precision. In those situations, it might be necessary to test a combination of management review controls and other controls to conclude on whether the company's controls sufficiently address the risks of material misstatement for the relevant assertions of significant accounts.
Information Technology Considerations, Including System-generated Data and Reports

The general inspection report notes that inspections staff have observed instances in which firms selected controls for testing but failed to sufficiently test controls over the completeness and accuracy of system-generated data or reports used in the operation of those controls. For example, some firms failed to: (1) test ITGCs that are important to the effective operation of the applications that generated the data or reports, (2) test the logic of the queries (or parameters) used to extract data from the IT applications used in the reports, or (3) address control deficiencies that were identified with respect to the ITGCs over either the applications that process the data used in the reports or the applications that generated the reports.\(^{49}\) Similarly, inspections staff have observed instances in which firms have identified that certain ITGCs were ineffective but failed to perform other procedures to test report writers and systems used to produce spreadsheets, queries, or reports. In other instances, the firms planned their tests of controls to include testing of ITGCs for IT-dependent controls, but those IT-dependent controls used customized data or queries that were not subject to the ITGCs the firms tested.

A company's use of IT can significantly affect a company's internal control. The following are examples of IT-related matters that can affect the auditor's evaluation of internal control:

- Risks of material misstatement resulting from the company's IT processes or systems;\(^{50}\)
- Important controls that depend on the effectiveness of IT controls ("IT-dependent controls"), for example, because they use system-generated data or reports; and
- Important IT controls, such as, automated controls that address risks of material misstatement to one or more assertions, along with the IT controls that support the effectiveness of the automated controls.

\(^{49}\) See the general inspection report at 11.

\(^{50}\) See, e.g., paragraphs 36 and 47 of Auditing Standard No. 5 and paragraphs B1-B6 and 29 of Auditing Standard No. 12.
PCAOB standards require the auditor to obtain an understanding of the company's information system relevant to financial reporting and take into account IT considerations in assessing the risks of material misstatement. This includes obtaining an understanding of the extent of manual controls and automated controls used by the company, including the ITGCs that are important to the effective operation of the automated controls.\textsuperscript{51} The auditor also should obtain an understanding of specific risks to a company's internal control resulting from IT.\textsuperscript{52}

In an audit of internal control, if the auditor selects an IT-dependent control for testing, the auditor should test the IT-dependent controls and the IT controls on which the selected control relies to support a conclusion about whether those controls address the risks of material misstatement.\textsuperscript{53} For example, if a control selected for testing uses system-generated data or reports, the effectiveness of the control depends in part on the controls over the accuracy and completeness of the system-generated data or reports. In those situations, supporting a conclusion on the effectiveness of the selected control involves testing both the selected control and the controls over the system-generated data and reports.

As discussed later in this alert, PCAOB standards require evaluation of the severity of identified control deficiencies. This includes deficiencies in IT controls. However, the nature of IT systems, processes, and controls can affect how deficiencies in IT controls should be evaluated. For example, an IT control might not be intended to prevent or detect misstatements by itself, but it might impair the effectiveness of important IT-dependent controls if it were deficient. In those situations, evaluating the severity of a deficient IT control involves assessing the effect of the deficiency on important IT-dependent controls and, in turn, the likelihood and magnitude of potential misstatements that could result, individually or in combination with other control deficiencies. Also, deficient IT controls might impair the effectiveness of multiple controls across multiple accounts. In those situations, it may be necessary to assess the severity of those impaired controls

\textsuperscript{51} See paragraph B1 of Auditing Standard No. 12.

\textsuperscript{52} See paragraph B4 of Auditing Standard No. 12.

\textsuperscript{53} See, e.g., paragraphs 39-41 of Auditing Standard No. 5, which discuss selecting controls to test and paragraph 47 of Auditing Standard No. 5, which cite situations in which controls rely on the effectiveness of IT general controls.
in combination across the affected accounts and with other control deficiencies affecting those accounts.

Roll-forward of Controls Tested at an Interim Date

The general inspection report notes that inspections staff have identified instances in which firms tested significant controls at an interim date and either did not perform any testing, or used inquiry alone, to update the results of their testing of higher risk controls that had been performed prior to year end. For example, an engagement team performed tests of highly subjective controls during the interim period, three to six months prior to year end. Yet the engagement team's procedures to update the results of its testing of these controls from the interim date to year end were limited to general inquires as to whether the operation of any of these controls had changed, despite higher degrees of risks associated with these controls, including, in some cases, high inherent risks or heightened fraud risks. In another example, the engagement team's procedures to update the results of its testing of internal control for the six-month period from the interim date to year end were limited to inquiry, including for higher-risk controls and controls affected by a change in management review and approval responsibilities.\footnote{54}{See the general inspection report at 10.}

Although the auditor expresses an opinion on internal control as of the end of the year, auditors may decide to test some important controls at an earlier date. When auditors test controls at an interim date, PCAOB standards require auditors to perform "roll-forward" procedures to update the results of interim testing to year end.\footnote{55}{See paragraph 55 of Auditing Standard No. 5. If the auditor plans to rely on controls in the financial statement audit, the auditor must obtain evidence about the controls over the entire period of reliance, as discussed in paragraphs 16 and 29-30 of Auditing Standard No. 13.} The amount of evidence needed from the roll-forward procedures depends on the following factors:

- The specific control tested at an interim date, including the risks associated with the control and the nature of the control, and the results of those tests;
The sufficiency of the evidence of effectiveness obtained at an interim date;

- The length of the roll-forward period; and

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.  

Auditing Standard No. 5 provides that inquiry might be a sufficient roll-forward procedure when evaluation of the preceding factors indicates a low risk that the controls are no longer effective during the roll-forward period. For example, inquiry might be appropriate if the risk associated with the control were low, the auditor obtained substantially all of the evidence necessary to support the conclusion on the control as of the interim date with no observed test exceptions, the roll-forward period was relatively short, and there were no significant changes in internal control during the roll-forward period. Conversely, inquiry is unlikely to be sufficient if the control is more complex, subjective or otherwise higher risk; the control was not tested extensively at the interim date; exceptions were noted in the interim testing; the roll-forward period spans a significant portion of the year; or significant changes occurred in internal control during the roll-forward period. Similarly, when inquiry is not sufficient, the additional evidence to cover the roll-forward period cannot be inferred from the absence of misstatements detected by substantive procedures.

Using the Work of Others

The general inspection report notes that inspections staff have identified situations in which firms used the work of others, most often internal audit, who performed tests of controls without establishing a sufficient basis for using that work. For example, in some instances, the extent to which firms used the work of internal audit in higher risk areas involving significant judgment, such as aspects of revenue and the valuation of complex, hard-to-value investment securities, was inappropriate. Also, in some instances, firms failed to evaluate the design of

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56/ See paragraph 56 of Auditing Standard No. 5.
57/ Id.
58/ See paragraph B9 of Auditing Standard No. 5.
internal audit’s control testing procedures, including the scoping and the identification of important controls. For example, the engagement team used the work of internal audit to test controls over revenue. The engagement team did not re-perform any of the tests of controls performed by the issuer’s internal audit group. In addition, there was no documentation of the nature, timing, and extent of the control testing performed by internal audit.\textsuperscript{59/}

PCAOB standards allow the auditor to use the work of others as evidence of the effectiveness of selected controls, and Auditing Standard No. 5 requires auditors to determine the extent to which the work of others will be used.\textsuperscript{60/}

PCAOB standards provide that the extent to which the work of others can be used depends on the following factors:

- The risk associated with the control being tested,\textsuperscript{61/} and

- The competence and objectivity of the persons whose work the auditor plans to use.\textsuperscript{62/} For example, persons who test controls are less objective if they report to those responsible for the operation of the controls being tested.

The risk associated with the control is the risk that a control might not be effective and, if not effective, that a material weakness would result.\textsuperscript{63/} Auditing Standard No. 5 discusses factors that affect the risk associated with a control, including the complexity of the control and significance of judgments that must be made in connection with its operation and the inherent risks of the related account or assertion.\textsuperscript{64/} As the risk associated with the control increases, the

\textsuperscript{59/} See the general inspection report at 12.

\textsuperscript{60/} See paragraphs 16-17 of Auditing Standard No. 5.

\textsuperscript{61/} See paragraph 19 of Auditing Standard No. 5.

\textsuperscript{62/} See paragraph 18 of Auditing Standard No. 5 and paragraphs .09-.11 of AU sec. 322, The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements.

\textsuperscript{63/} See paragraph 46 of Auditing Standard No. 5.

\textsuperscript{64/} See paragraph 47 of Auditing Standard No. 5.
need for the auditor to perform his or her own testing of the control increases.\textsuperscript{65/}

In higher risk areas, such as testing complex controls, controls that address specific fraud risks, or controls that require significant judgment to operate or evaluate, use of the work of others would be limited, if at all.\textsuperscript{66/} Conversely, the work of competent and objective persons could be used more extensively in lower risk areas.

PCAOB standards provide direction on evaluating the competence and objectivity of others.\textsuperscript{67/} The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The impact of the work of others on the auditor’s work also depends on the relationship between the risk associated with the control and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases.\textsuperscript{68/}

When the auditor uses the work of others, the auditor also should test and evaluate that work, including evaluating the quality and effectiveness of the others’ work.\textsuperscript{69/} The necessary extent of testing of that work depends on the risk associated with the control and the competence and objectivity of the others. More extensive testing of the others’ work is needed as the risk increases or the others’ level of competence or objectivity decreases. When using the work of

\begin{footnotes}
\item[65/] See paragraph 19 of Auditing Standard No. 5.
\item[67/] See paragraph 18 of Auditing Standard No. 5 and AU sec. 322.09-.11. For example, the objectivity of the others is lower when they report directly to management or to the person performing the control they are evaluating.
\item[68/] See PCAOB Release 2007-005A at 14.
\item[69/] See paragraph 16 of Auditing Standard No. 5 and AU sec. 322.24-.27. See also PCAOB Release 2007-005A at A4-4.
\end{footnotes}
others that provide direct assistance, the auditor should supervise that work, including reviewing the work, as well as testing and evaluating it.\footnote{Id.}

**Evaluating Identified Control Deficiencies**

The general inspection report notes that inspections staff observed instances in which firms failed to evaluate sufficiently the severity of the control deficiencies that they had identified. Specifically, in some cases firms did not:

- \textit{Sufficiently evaluate whether audit adjustments and exceptions identified from substantive procedures were indicators of the existence of control deficiencies.} For example, the firm's valuation specialist concluded that the recorded fair values of certain of the issuer's assets were outside a reasonable range due to the use of unsupported assumptions. This resulted in a significant audit adjustment that the issuer recorded. The issuer's controls had failed to identify that the valuation assumptions were not supported; however, the engagement team failed to identify and evaluate this control deficiency.

- \textit{Consider all of the relevant risk factors that should have affected the determination of whether there was a reasonable possibility that a deficiency, or a combination of deficiencies, could result in a material misstatement.} For example, a significant deficiency was identified over the issuer's process for valuing hard-to-value financial instruments. The engagement team failed to appropriately evaluate the severity of the deficiency as it did not evaluate relevant risk factors, such as, the nature of the accounts affected by the deficiency, and the subjectivity, complexity, or extent of judgment required to determine the valuations. In addition, the engagement team did not consider the magnitude of audit adjustments related to this control deficiency in determining whether the control deficiency was a material weakness rather than a significant deficiency.

- \textit{Consider all of the relevant factors that should have affected the determination of the magnitude of potential misstatements.} For example, an engagement team did not sufficiently evaluate the severity of certain control deficiencies identified through tests of
controls over revenue. Specifically, as part of the issuer’s evaluation of control deficiencies, management calculated the magnitude of the potential misstatement resulting from the control deficiencies using certain significant assumptions. The engagement team used the issuer’s evaluation but did not assess the reasonableness of the issuer’s assumptions.

- Sufficiently evaluate compensating controls, including identifying and testing those controls and determining whether they operated at a level of precision that would prevent or detect a misstatement that could be material. For example, an engagement team concluded that certain compensating controls partially mitigated the effect of the deficiencies and that the control deficiencies therefore constituted a significant deficiency rather than a material weakness. The engagement team, however, failed to obtain sufficient appropriate audit evidence to support its conclusion that the compensating controls operated at a level of precision that would prevent or detect a misstatement that could be material. Specifically, the engagement team concluded that one of the compensating controls operated effectively even though the control failed to identify an error that was in excess of the engagement team’s established materiality.\(^{71/}\)

Control deficiencies might be identified during the audit of the financial statements as well as the audit of internal control. For example, an error identified in the financial statement audit often results from a deficiency in the design or operation of controls, or a lack of controls, over that account or disclosure. PCAOB standards require auditors to evaluate the effect of the findings of the substantive procedures performed in the financial statement audit on the effectiveness of internal control.\(^{72/}\) This includes identifying and evaluating any specific control deficiencies related to the identified misstatements.

PCAOB standards require auditors to evaluate the severity of each control deficiency that comes to his or her attention to determine whether the

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\(^{71/}\) See the general inspection report at 13-14.

\(^{72/}\) See paragraph B8 of Auditing Standard No. 5.
deficiencies, individually or in combination, are material weaknesses.\textsuperscript{73/} Auditing Standard No. 5 provides that the severity of a control deficiency depends on (1) whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure and (2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies.\textsuperscript{74/} The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.\textsuperscript{75/}

Auditing Standard No. 5 also provides additional direction on evaluating the severity of control deficiencies, including risk factors that affect the evaluation of the likelihood and potential magnitude of misstatements resulting from control deficiencies and indicators of material weaknesses.\textsuperscript{76/} For example, deficiencies in controls over the key assumptions in a significant accounting estimate could result in a reasonable possibility of misstatement because of the subjectivity, complexity, or extent of judgment required to determine the amount of the estimate. Also, multiple control deficiencies affecting the same account can increase the likelihood of misstatement. Similarly, the magnitude of potential misstatements resulting from a deficiency is greater for control deficiencies affecting processes with large transaction volumes or the existence of accounts with large recorded amounts.

In forming a conclusion about whether a control deficiency or combination of deficiencies is a material weakness, the auditor should evaluate the effect of compensating controls, if any. This includes testing the compensating controls to determine whether they operate at a level of precision that would prevent or detect a misstatement that could be material. This includes evaluating whether the control addresses the risk of material misstatement to the relevant assertion.

\textsuperscript{73/} See, e.g., paragraph 62 and the second note to paragraph 65 of Auditing Standard No. 5.

\textsuperscript{74/} See paragraph 63 of Auditing Standard No. 5.

\textsuperscript{75/} See paragraph 64 of Auditing Standard No. 5.

\textsuperscript{76/} See paragraphs 64-70 of Auditing Standard No. 5, which set forth additional requirements and direction regarding evaluating the severity of control deficiencies.
intended to be addressed by the deficient control. If the compensating control is a management review control, the previously discussed considerations for testing management review controls apply to the compensating control.

Evaluating whether a control deficiency, or a combination of control deficiencies, results in a material weakness requires professional skepticism and a careful analysis of all the evidence obtained. Auditors who perform a mechanical or cursory evaluation of deficiencies might reach premature conclusions without appropriately considering critical information. For example, a mechanical or cursory evaluation may lead an auditor to

- Assess control deficiencies in isolation, without considering the effects of deficiencies in combination;
- Consider only the amount of identified misstatements, without evaluating the magnitude of potential misstatement that could occur; or
- Focus on a checklist of material weakness indicators without considering other relevant factors.

Conclusion

An integrated audit of financial statements and internal control benefits investors because the auditor’s reports address both the audited financial statements and the effectiveness of the controls the company uses to produce its financial statements. Appropriate application of the top-down, risk based approach pursuant to PCAOB standards can result in an effective audit of internal control while avoiding unnecessary work.

The PCAOB has observed through its inspections a significant number of audit deficiencies in audits of internal control over the past three years. This alert discusses certain significant matters relating to the application of PCAOB standards to audits of internal control, in light of these inspections observations.

Auditors should take note of the matters discussed in this alert in planning and performing their audits of internal control. Because of the nature and importance of the matters covered in this alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews. Auditing firms also should consider whether additional training of their auditing personnel is needed for the topics discussed in this alert.
Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditors' internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings and ask how they are addressing the matters discussed in this alert. In particular, audit committees may want to inquire about the involvement and focus by senior members of the firm on these matters.

As noted in the general report, audit committees may consider inquiring of the issuer's auditor how the controls to be tested will address the assessed risks of material misstatement for relevant assertions of significant accounts and disclosures. Also, audit committees may consider discussing with the auditor his or her assessment of risks, evaluation of control deficiencies, and whether the auditor has adjusted as necessary the nature, timing, and extent of his or her control testing and substantive audit procedures in response to risks related to identified control deficiencies.

The PCAOB will continue to monitor the execution of audits of internal control as part of its ongoing oversight activities.

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COSO issues the updated Internal Control-Integrated Framework and related illustrative documents

Overview

Background

.1 In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued the original Internal Control—Integrated Framework (original framework). The original framework, authored by PwC under the direction of COSO, has been widely adopted by organizations around the world in designing, implementing, and conducting systems of internal control, especially with respect to internal control over financial reporting.

.2 On May 14, 2013, COSO published an updated Internal Control—Integrated Framework (Framework) and related illustrative documents. These publications, authored by PwC under the direction of COSO, include the:

i. Internal Control-Integrated Framework: Executive Summary (Executive Summary),

ii. Internal Control-Integrated Framework: Framework and Appendices (Framework),

iii. Illustrative Tools: Assessing Effectiveness of a System of Internal Control (Illustrative Tools), and


.3 COSO’s goals for updating the original framework is to (i) clarify the requirements of effective internal control, (ii) update the context for applying internal control to many changes in business and operating environments, and (iii) broaden its application by expanding the operations and reporting objectives. COSO developed the related illustrative documents to provide tools to assist companies in implementing or evaluating their system of internal control and offer specific approaches and examples as to how the Framework applies to external financial reporting.
.4 COSO has stated that the key concepts and principles embedded in the original framework are fundamentally sound and broadly accepted in the marketplace; accordingly, COSO has updated and not fundamentally overhauled the original framework.

.5 To help develop these publications, COSO formed an Advisory Council comprising representatives from industries, academia, government agencies, and non-profit entities, as well as regulatory observers and standard setters also provided input as the project progressed. In addition, exposure drafts of these publications were issued for public comments and COSO received more than 100 public responses to its on-line survey and another 97 public comment letters from stakeholders around the world.

.6 On March 20, 2013, COSO announced that the original framework will be available via www.coso.org through December 15, 2014, after which time COSO will consider it as superseded by the Framework. COSO recommended that all organizations currently using the original framework should begin to align existing practices (and related documentation) to the Framework as soon as is feasible under their particular circumstances. It also observed the original framework can continue to be used during the transition period, and that an organization that reports externally should clearly disclose whether it utilized the original framework or the updated Framework.

.7 The possible impacts of adopting the Framework will vary and depend upon many factors, including how well the organization understood and applied the key concepts and principles contained in the original framework. The articulation of principles in the Framework and consideration of many changes in business and operating environments over the past several decades may impact the design, operation and/or documentation relating to existing systems of internal control. In addition, the Framework allows for broader application of internal control to operations and non-financial reporting objectives.

.8 Refer to PwC’s 10Minutes - on why the COSO update deserves your attention for further insights regarding COSO’s update of the Framework.

**The main details**

.9 COSO has stated the Framework is expected to help organizations design and implement internal control in light of many changes in business and operating environments since the issuance of the original framework, broaden the application of internal control in addressing operations and reporting objectives, and clarify the requirements for determining what constitutes effective internal control.

.10 The Executive Summary provides a high-level overview intended for the board of directors, chief executive officer, and other senior management. The Executive Summary informs leaders how the Framework builds on the core strengths of what has been proven useful in the original framework.

.11 The Framework defines internal control and describes the requirements for effective internal control. The Framework sets forth, and describes in some detail, the five components and seventeen associated principles of a system of internal control. Further, it illustrates application relating to operations, reporting and compliance objectives, and provides direction for all levels of management to use in designing, implementing and conducting a system of internal control, and in assessing its effectiveness.

.12 The Illustrative Tools provide templates and scenarios that may be useful for management when using the Framework to assess the effectiveness of a system of internal control based on the requirements set forth therein.
The ICEFR Compendium is a companion document to the Framework and illustrates additional approaches and examples of how the principles set forth in the Framework can be applied in the context of external financial reporting, a subset of the reporting category of objectives.

COSO has stated the key concepts and principles embedded in the original framework are fundamentally sound and broadly accepted in the marketplace. Accordingly, COSO acknowledges continued use of the original framework during the transition period (May 14, 2013 to December 15, 2014) is appropriate. During this period the COSO Board believes that organizations complying with requirements to report on the effectiveness of their system of internal control should clearly disclose whether the original framework or updated Framework was utilized.

COSO has recommended users of the original framework to transition their current applications and related documentation to the Framework as soon as is feasible under their particular circumstances. For example, an organization with a less complex system of internal control over external financial reporting may be able to make all appropriate changes to its system and documentation in a few months; whereas, an organization with a more complex system may take a longer period to implement changes.

This Dataline highlights noteworthy updates to the Framework relating to internal control over external financial reporting, such as the requirements set out for effective internal control. It also summarizes the purpose of the illustrative documents relating to the Framework and highlights key considerations for clients, such as those changes that are expected to impact management’s assertion on the effectiveness of the entity’s system of internal control over financial reporting in compliance with the Sarbanes-Oxley Act.

**Key provisions**

**Noteworthy updates to the Framework**

The original framework was introduced in 1992 and has been widely adopted worldwide. In response to an increasingly complex, technologically driven, and global business environment, COSO recently published the Framework to address key issues for future organizational success. The Framework does not fundamentally alter the key concepts contained in the original framework; rather, it clarifies and builds on core strengths by (i) formalizing these concepts embedded within the five components into seventeen principles, (ii) considering changes in business and operating environments, and (iii) expanding the financial reporting objective to address other important forms of reporting.

PwC observation:

We believe the Framework will assist management, boards of directors, external stakeholders, and others interacting with the entity, regarding an entity’s application of internal control in the preparation of external financial statements, and should provide the organization with more confidence in knowing that the requirements of effective internal control are met without being overly prescriptive or burdensome.

The Framework provides an integrated approach for applying internal control through understanding the connections of specific objectives, risks, and controls across the business. Further, an integrated approach may address risks associated with overlapping objectives. We believe that internal control can be a powerful tool to help organizations achieve their specified objectives. While internal control always has been designed for broader application than external financial reporting, we
believe an integrated approach could help management identify and assess risks across the business and embed greater accountability for achieving financial reporting objectives.

The Appendices provide reference material, including a glossary of key terminology, a discussion of roles and responsibilities, a discussion of the methodology used for developing the Framework, a discussion of comment letters received during the public exposures of the proposed drafts of the Framework and related illustrative documents, a summary of changes to the original framework, and a comparison with the COSO Enterprise Risk Management-Integrated Framework.

.18 One of the more significant updates to the Framework is the formalization of fundamental concepts introduced in the original framework into seventeen principles associated with the five components of internal control—Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities. These principles, which were implicit in the original framework, are now explicitly set out to increase the ease of use and broaden the application of the Framework. They also provide clarity for understanding the requirements of effective internal control and facilitate designing and implementing a system of internal control and in assessing its effectiveness.

.19 The Framework also includes points of focus that highlight important characteristics of the principles. Points of focus may assist management in designing, implementing and conducting internal control and in determining whether relevant principles are, in fact, present and functioning.

PwC observation:

The Framework essentially retains the core definition and the five components of internal control. We believe the articulation of principles and related points of focus will assist organizations in designing controls for achieving their specific objectives, mitigating risk to acceptable levels, and adapting to changes in business and operating environments, while not imposing a higher threshold or additional burden to achieve effective internal control. While no separate evaluation of points of focus is required to demonstrate that a relevant principle is present and functioning, we believe they may be very useful in mapping principles to existing controls embedded within each of the five components.

We believe the principles-based Framework is more flexible and adaptable, and broadly applicable than a rules-based framework. The Framework acknowledges the important role of management judgment in determining whether principles are relevant to the entity and present and functioning across the business. The principles help organizations to specify and communicate suitable objectives, to identify and assess related risks, and to select and deploy controls across the business. Further, since the principles are suitable for operations, reporting, and compliance objectives, they can provide a common approach for achieving multiple objectives.

Requirements for effective internal control

.20 The Framework requires that an effective system of internal control reduces, to an acceptable level, the risk of not achieving an objective relating to one, two, or all three categories of objectives – operations, reporting, or compliance. Management is expected to obtain persuasive evidence to support its determination that each of the components and relevant principles is present and functioning and the five components are operating together in an integrated manner.
In making the determination as to whether each component and relevant principle is present and functioning, management considers controls across the business that effect the component or relevant principle. Controls that effect a principle may be found in one or more components. Understanding and considering how controls effect multiple principles can provide persuasive evidence to support management’s assessment of whether components and relevant principles are present and functioning.

PwC observation:
We believe management should map relevant principles to existing controls across the business to ascertain if there is persuasive evidence that these controls sufficiently effect such principles are present and functioning or require clarification, or even to be strengthened, to demonstrate that components and relevant principles are present and functioning. We further believe the update will focus management’s attention as to whether relevant principles are present and functioning since this is a primary factor in determining whether each of the five components of internal control operate together.

An effective system of internal control does not require that management assess separately whether any points of focus are in place. In fact, the Framework recognizes the possibility that some of the presented points of focus may not be suitable or relevant and that management may identify others based on specific circumstances of the entity. The points of focus should be considered as important considerations that can support management’s determinations as to whether relevant principle(s) are present and functioning.

Similarly, the Framework does not prescribe requirements that any particular controls are in place. Clearly, management must consider how controls effect principles through their selection, development, and deployment, in conjunction with their gathering persuasive evidence to support its determination that each of the components and relevant principles is present and functioning. Management exercises judgment in selecting, developing, and deploying controls necessary to effect principles.

Deficiencies in Internal Control over Financial Reporting
The Framework defines an internal control deficiency as a shortcoming in one or more components and relevant principle(s) that reduces the likelihood that an entity can achieve its objectives. If, in management’s judgment, a control deficiency severely reduces that likelihood, then it is defined as a major deficiency under the Framework. The existence of a major deficiency precludes an organization from concluding that it has met the requirements for an effective system of internal control.

The Framework recognizes that regulators, standard-setting bodies, and other relevant third parties establish criteria for defining the severity of, evaluating, and reporting internal control deficiencies. Further, the Framework recognizes and accommodates their authority and responsibility as established through laws, rules, regulations, and external standards. In those instances where an entity must comply with criteria established by the United States Securities and Exchange Commission (SEC), a company uses the definition and guidance set out for classifying internal control deficiencies as a material weakness, significant deficiency, or control deficiency as pertaining to financial reporting.
PwC observation:

The Framework sets out descriptions of deficiencies (internal control deficiency, major deficiency) that contrast with those set forth in the original framework (control deficiency, significant deficiency, and material weakness), which are now closely associated with external financial reporting. The updated descriptions contained in the Framework are equally applicable to all three categories of objectives, whereas the previous descriptions are not relevant for operations and certain aspects of the compliance objectives. Additionally, the broadening of the financial reporting objective supports a more generic description.

A major deficiency is not, by definition, equivalent to a material weakness, but the practical effect on the evaluation of a system of internal control is the same – the existence of either precludes management from concluding that the system of internal control is effective. In bridging the gap between the descriptions set out in the Framework and those established by regulators or standard setters with respect to evaluating operating effectiveness, we believe that any material weakness, significant deficiency, or control deficiency identified by management would ultimately relate to the determination of whether component(s) and relevant principle(s) of internal control are present and functioning. Therefore, we believe the Framework is suitable for the purpose of complying with regulatory requirements for reporting on the effectiveness of an entity's system of internal control over financial reporting.

Related illustrative documents

A Compendium of Approaches and Examples

.24 As part of the project to update the original framework, COSO developed additional approaches and examples that illustrate how the components and principles set forth in the Framework can be applied in preparing (i) financial statements for external purposes, and (ii) other external financial reporting derived from an entity's financial and accounting books and records.

.25 The approaches and examples are samples of activities for management to consider, rather than a complete or authoritative list. For each principle, the ICEFR Compendium lists approaches that generically illustrate how organizations can apply the principles to their system of internal control over external financial reporting. For each approach, one or more examples are provided to illustrate how an important aspect of the approach has been put in place by entities that prepare financial statements for external purposes. The approaches and examples also illustrate one or more points of focus corresponding to a particular principle. They are not designed to provide a comprehensive, end-to-end view of how principles may be fully applied in practice.
PwC observation:

The ICEFR Compendium is particularly relevant to users who publicly report on the effectiveness of their system of internal control over financial reporting based upon requirements set forth in the Framework. We believe the ICEFR Compendium provides useful illustrations of principles that are relevant for a variety of entities — public, private, not-for-profit, and government. The approaches and examples do not attempt to illustrate all aspects of each component or relevant principle necessary for effective internal control relating to an entity’s external financial reporting objective; instead, they provide a compendium of practical illustrations of particular aspects of the principles. It is not a "how to" guide for selecting and deploying specific controls.

The approaches and examples are not sufficient for an organization to determine that each component and relevant principle is present and functioning, but instead illustrate how principles may be present and functioning. As such, we caution entities from only referencing or reviewing the ICEFR Compendium. It is a companion document and a full review of the Framework is required to understand the requirements for effective internal control.

Illustrative Tools

.26 The Illustrative Tools can assist users when assessing the effectiveness of a system of internal control based on the requirements set forth in the Framework. The Illustrative Tools provide templates that focus on evaluating the components and relevant principles, not the underlying controls (e.g., transaction-level control activities) that effect the relevant principles. The templates can be modified to reflect the circumstances (e.g., specified financial reporting objectives and sub-objectives, scope of application, or organizational structure) and assessment processes relevant for any entity. The templates can support an assessment of the effectiveness of a system of internal control and help to document such an assessment.

.27 The scenarios illustrate several important aspects of an assessment of the effectiveness of a system of internal control, including (i) whether a single component and relevant principles are present and functioning and (ii) whether the five components are operating together in an integrated manner. The scenarios also illustrate several practical examples of how the templates can be used to support an assessment of the effectiveness of a system of internal control.

.28 The Illustrative Tools is not designed to satisfy any criteria established through laws, rules, regulations, or external standards for evaluating the severity of internal control deficiencies associated with a particular entity objective, such as external financial reporting.

What should companies start to think about?

.29 For users of the original framework, COSO has indicated the Framework will help organizations update their systems of internal control to reflect changes in business and operating environments during the last two decades, broaden the application of internal control to their operations, compliance and reporting objectives, and better understand the requirements for demonstrating effective internal control.
.30 For public companies that apply the original framework for compliance with Section 404(a) or (b) of the Sarbanes-Oxley Act of 2002, COSO has further indicated the Framework is not expected to fundamentally change an entity’s internal control over financial reporting or related assessment process. It has also recommended that management of these companies should begin to assess how each of the seventeen principles is present and functioning and the five components operate together in their circumstances.

.31 COSO has indicated that senior management should discuss with the board of directors its plan to adopt the Framework as soon as practical. The board of directors should oversee management’s assessment of any implications of, and determination of appropriate actions for, applying the Framework.

PwC observation:
We believe that all seventeen principles will be relevant to SEC filers and to most other entities because they have a significant bearing on the presence and functioning of the associated components of internal control. In those rare instances where a principle may not be relevant, the Framework requires management to support this determination with the rationale of how, absent that principle, the component can be present and functioning.

We believe that COSO’s requirement for effective internal control – each of the components and relevant principles are present and functioning and the components are operating together in an integrated manner – does not impose a higher threshold or more significant burden for management to demonstrate the entity’s internal control over financial reporting is effective.

We believe users of the Framework will first need to determine which principles are relevant for its business. Next, management will need to demonstrate, and provide persuasive evidence, that each of the relevant principles associated with the five components are present and functioning across the business. That evidence will generally entail mapping the relevant principles to existing controls within each of the components to assess whether such relevant principles are present and functioning in support of the entity’s objectives. The points of focus will be particularly useful in this respect. For any gaps in design, management will need to establish a process for identifying, assessing, and implementing necessary changes in controls and related documentation.

At the same time, we believe taking a fresh look at internal control over financial reporting will increase confidence through better understanding of how an organization considers the connections of specific financial reporting objectives and related risks and controls across business. In addition, determining whether each relevant principle is present and functioning across a business is expected to help identify and assess hidden risks, as well as new challenges and changes that introduce risks, of achieving external financial reporting objectives.

On a broader scale, the Framework provides an opportunity to refresh systems of internal control and consider new applications of the Framework. For example, controls designed to evaluate whether to accept a new customer agreement may (or may not) consider overlapping operational and internal reporting objectives, in addition to supporting a system of internal control over financial reporting. A comprehensive, integrated approach to internal control may help in designing controls to achieve multiple, overlapping objectives, and mitigate interdependent risks.
Transition

.32 On May 14, 2013, COSO published the Framework, Illustrative Tools, and ICEFR Compendium. COSO has previously announced that it will continue to make available the original framework during the transition period extending to December 15, 2014, after which time COSO will consider the original framework as having been superseded. In addition, the Internal Control over Financial Reporting—Guidance for Smaller Public Companies will be retired when the original framework is superseded.

.33 COSO has indicated that continued use of the original framework is appropriate during this transition period, and that any application of the Framework that involves external reporting should clearly disclose whether the original framework or updated Framework was utilized.

PwC observation:
We believe the transition period of May 14, 2013 to December 15, 2014 will provide sufficient time for organizations to evaluate their existing systems of internal control over financial reporting against the relevant principles set out in the Framework. We concur with COSO’s decision to recognize and support only the Framework as its Internal Control-Integrated Framework after December 15, 2014.

.34 COSO has indicated that users of the original framework should transition their applications and related documentation to the Framework as soon as is feasible under their particular circumstances. As noted previously, during the transition period, COSO acknowledges that organizations that must comply with regulatory requirements for reporting on the effectiveness of their internal control over external financial reporting should clearly disclose whether the original framework or updated Framework was utilized.

PwC observation:
We also encourage users of the original framework to assess as soon as practical any implications of transitioning to the updated Framework and to determine what, if any, new or modified controls and documentation are needed. Then, management should deploy any such controls and update related documentation needed to transition timely applications to the Framework. We understand differing circumstances will impact the extent of time necessary for users to assess and implement any necessary changes in the design, operations or related documentation.

We believe companies could meet COSO’s recommendation by referring to the extant framework as “Internal Control–Integrated Framework (1992)” and the not yet effective framework as “Internal Control–Integrated Framework (2013)”.

Questions

.35 PwC clients who have questions about this Dataline should contact their engagement partner. PwC engagement teams that have questions can obtain additional information on Spark or kCurve or send an inquiry to ICIF@us.pwc.com.

.36 In addition, further information regarding the Framework and related illustrative documents can be found on the COSO website www.coso.org.
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Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments

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Washington, D.C.
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Introduction

Good morning.

As Dan [Murdock] mentioned, the OCA current projects panel is back this year. For those that recall remarks from prior years, I don’t think we have any update on views on whether bowling is a sport. But, we are happy to share our individual views on accounting, auditing, and internal control matters.

As we all know, the objective of internal control over financial reporting (ICFR) is to provide reasonable assurance regarding the reliability of financial reporting. So perhaps it’s fitting that I’m speaking first amongst us, as I will supplement Brian Croteau’s comments on ICFR from the previous panel. My focus will primarily be on certain aspects of evaluating control deficiencies. Some of these insights stem from the involvement OCA has had with the Division of Corporation Finance over the past year supporting the Disclosure Review Program.

In evaluating ICFR, the staff continues to believe that the top-down, risk-based approach described in the Commission Guidance is typically most effective at providing a reasonable basis for determining whether any material weaknesses exist. This “top-down” focus can be important to helping ensure that sufficient considerations are made when identifying and describing a deficiency. Otherwise, in the case of identified misstatements, management might find itself focused too narrowly on information about what happened as opposed to considering more holistically what could happen in the context of current and evolving financial reporting risks. As an example, consider a company that identifies an immaterial prior period error in one revenue stream. The company is growing and entering into new lines of business, but has not employed sufficient resources in the finance department to keep up. Obviously, this raises questions about what other amounts or disclosures could be impacted by the lack of resources and how the Control Environment and Risk Assessment components of COSO had been evaluated.

Understanding the Cause of the Control Deficiency

Moving on, much of the dialogue we have with companies relates to deficiencies within the Control Activities component. For material weaknesses, as part of the disclosure, Commission Guidance states that
"companies should also consider providing disclosure that allows investors to understand the cause of the control deficiency."

This is important information because, among other things, it can aid investors in assessing the potential impact to the financial statements of a material weakness. I believe, however, that management needs to understand the cause of all control deficiencies. Otherwise, management is more likely to overlook the possibility that there is a deficiency in another COSO component that may already represent, or could otherwise be developing into, a material weakness.

While it is possible that some transaction-level control failures are isolated within the Control Activities component, the cause may often stem from a broader breakdown, and the nature of the deficiency will provide clues as to what that cause may be. For example, a company that describes a deficiency in the design of one or more Control Activities controls may receive a follow up request from the staff for information about how management considered the effectiveness of the Risk Assessment component. Likewise, a company that describes a deficiency in the operating effectiveness of one or more Control Activities controls may receive a follow up request from the staff for information about how management considered the effectiveness of the Monitoring Activities component.

Such determinations are, of course, fact- and circumstance-based and likely to vary from company to company based on the number of transaction-level deficiencies that exist, the nature of each deficiency, and the financial statement amounts or disclosures affected, among other factors. However, without understanding the cause of each identified deficiency, management may not be in a position to appropriately evaluate the effectiveness of each of the components of internal control. More broadly in this regard, I am hopeful that the improved organization and structure of COSO 2013 versus the 1992 version, through the use of principles and points of focus, leads to improved evaluations of the components outside of Control Activities.

**Identifying Financial Reporting Risks**

Having just mentioned the relationship of the effective design of Control Activities controls to the Risk Assessment component, it might be helpful now to provide a reminder about a key point for identifying financial reporting risks.

As part of its ongoing assessment of “what could go wrong” within a financial reporting element, it is critical that management consider the nature and extent of any changes in the risks to reliable financial reporting. Such changes can result from a variety of sources, including company reorganization, nature of transactions entered into, overall business environment, and accounting requirements. A few recent examples of such events discussed with registrants in the comment process include:

- Expansion into a new foreign location;
- Growth in operations through the use of variable interest entities (VIEs);
- Reaching a sales agreement with a new customer under terms different from those with any existing customer; and
- Increases in expenditures for environmental clean-up of existing remediation sites.

Let me now move on to two important points that have come up in many of the recent ICFR comment processes stemming from immaterial error corrections: a fully and accurately defined control deficiency, and the potential misstatement resulting from the deficiency, which is sometimes referred to as "the could factor."
Fully and Accurately Defined Control Deficiency

First, to be clear, an explanation of the accounting error that resulted from, or could result from, the deficiency, is important to understanding the nature of the deficiency. However, describing the accounting error is not the same as describing the control deficiency. Unfortunately, in initial responses to staff comments, and even in material weakness disclosures, we sometimes see statements that focus only on the error. Such statements may raise questions about management’s understanding of the implications of the deficiency and whether its severity was appropriately evaluated. Furthermore, investors might reasonably question how a company could remediate a control deficiency that it has failed to describe appropriately.

Factors that I have found helpful to consider in understanding and describing a deficiency include, but may not be limited to, the following:

- Nature of the control deficiency – For example, is it a design issue? Is the issue narrow or could the deficiency be broader than what has been observed?
- Impact – What is its impact on financial reporting and ICFR?
- Cause – As I discussed earlier, what is its cause?
- Identification – How was it discovered? For example, by management or the auditor? If by management, was it identified “accidentally” or as part of the normal operation of controls?
- Remediation – What measures are likely necessary to rectify the deficiency?

Notably, in some instances, the company’s thought process evolves over the comment process and it appears that management may be properly evaluating the deficiencies for the first time during this process, as we see changes in conclusions regarding nature, component, impact, and cause of identified deficiencies. Undoubtedly, these types of determinations require judgment. However, to ensure that investors receive timely information about management’s assessment of ICFR, these determinations need to be contemporaneous.

“The Could Factor”

Management evaluates the severity of a deficiency in ICFR by considering, in part, “the magnitude of the potential misstatement resulting from the deficiency or deficiencies.” Thus, the actual error is only the starting point and the potential impact should be considered as well. As with many aspects of the ICFR evaluation, careful consideration is required when evaluating “the could factor.”

In spite of this, some companies we have discussions with initially appear to equate the actual error identified with the reasonably possible potential misstatement. They do so despite the fact that the control did not ultimately detect the error. Essentially, these companies are taking the position that had the error been a dollar more, either the control or a compensating control would have prevented or detected it in a timely manner. Taking such a position, however, requires an appropriate evaluation of whether the control operates at a level of precision to do so.

Considering the nature of the deficiency is an important next step in determining the magnitude of the potential misstatement. This requires considering the nature of the transactions and the amounts or total of transactions exposed to the deficiency. It also requires considering not only the current volume of activity exposed to the deficiency but also the volume of activity that is expected in future periods. Determining the activity exposed to the deficiency includes considering whether it could reasonably be expected to affect other accounts. For example, for a deficiency...
resulting in an asset classification error in accounting for a business combination, the magnitude of the potential misstatement would ordinarily include not only the balance sheet impact, but also the reasonably possible subsequent income statement impact from amortization or impairment.

So why are there sometimes struggles in this area? From my experience, it often starts with a company not fully and accurately describing the deficiency. This may lead to a superficial thinking about the cause of the deficiency based on the error itself. This is convenient given that management has generally just completed its materiality assessment for the error; however, this generally will not result in a full understanding of the limitations of the control and is unlikely to result in developing and implementing sufficient remediation.

Conclusion

Let me conclude here by mentioning that our recent focus on the impact of immaterial errors on ICFR through the Disclosure Review Program is not intended to be a “gotcha” exercise. In addition to satisfying disclosure obligations, these interactions are opportunities for registrants to properly identify and remediate deficiencies in order to avoid recurrence and reduce the risk of material misstatements.

Thank you for your time today.


[iii] See Commission Guidance, at 15, which states, “A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed.”

[iv] See Commission Guidance, at 30, which states, “Management evaluates the evidence it gathers to determine whether the operation of a control is effective. This evaluation considers whether the control operated as designed. It also considers matters such as how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.”


[vi] For definition and discussion of compensating controls, see Commission Guidance, at 37.

Lease re-deliberations drawing to a close
The impact of recent decisions

At a glance

The FASB and IASB each issued a revised Leases Exposure Draft in May 2013 that attracted significant comments from stakeholders, and which prompted the Boards to reconsider key elements of the proposed standard. Although some aspects of the initial proposal have changed, and convergence between the FASB and IASB appears unlikely, the key objective, to bring most leases on balance sheet, has been met.

As re-deliberations draw to a close, the FASB has retained a dual income statement model with classification of different types of leases similar to today. The IASB, on the other hand, has decided to require lessees to reflect all leases as financings. Over the past two years, there have also been other changes to the initial proposal related to classification, measurement, and disclosure.

We expect final standards from the FASB and IASB before the end of 2015.

Background

.1 Leasing arrangements address a wide variety of business needs - from short-term asset use to long-term asset financing - and are sometimes the only option available to obtain the use of a physical asset (e.g., one floor of an office building or a single store in a mall). Some have long argued that the current accounting model is inadequate, as it allows lessees to structure lease transactions to achieve off-balance sheet financing.

.2 Proposals to revise lease accounting were brought onto the Boards’ agendas in 2007 as part of their global convergence effort. The Boards have issued two exposure drafts, one in 2010 and the other in 2013 (the “revised ED”), and have undertaken extensive outreach. Following the conclusion of the comment letter process in September 2013, the Boards began re-deliberations to address the concerns raised by stakeholders.

Key provisions

.3 For lessees, the Boards have continued to support balance sheet recognition for most leases and have retained, but clarified, previous proposals regarding how to determine whether an arrangement is (or contains) a lease. Although in agreement on how to identify a lease, the Boards have been unable to arrive at a converged proposal regarding classification, with each Board voting for different changes to the guidance proposed in their respective exposure drafts.
The FASB has continued to support a dual approach for classifying leases based on criteria similar to current U.S. GAAP – rejecting classification based on the nature of the underlying asset, as had been proposed in the 2013 revised ED. The FASB will require a lease to be presented as a financing (similar to capital leases today) in the income statement (referred to as a Type A lease) when (1) payments represent substantially all of the fair value of the asset, (2) the lease term is for a major portion of the asset’s economic life, (3) purchase of the asset is considered a bargain, or (4) title transfer is automatic at the end of the lease. The fair value and economic life tests are expected to be similar to the 90% and 75% tests under existing U.S. GAAP guidance, albeit without the bright lines.

All other leases would be classified as Type B, with costs presented as lease expense and recognized on a straight-line basis in the income statement over the lease term. This would produce an expense recognition pattern that is similar to operating leases under current U.S. GAAP.

In contrast, the IASB has decided to require all leases to be presented as financings, given their belief that this approach is conceptually superior and that a single model will be easier to apply than a dual approach.

Regardless of the differences in lease classification will impact the income statement, the Boards agree that on the balance sheet, lessees should initially recognize a right-to-use asset and lease liability based on the discounted payments required by the lease. The only exception to this presentation will be for short-term leases (i.e., a term of one year or less), which would not be recognized on a lessee’s balance sheet.

For lessors, in light of significant stakeholder concerns, the Boards voted to eliminate the “receivable and residual” approach proposed in the revised ED. This would have treated all leases as a sale, resulting in de-recognition of the leased asset. Real estate lessors in particular voiced concern about the resulting complexity when applied to the lease of a portion of an asset (e.g., a floor of a building being leased to a single tenant). Instead, the Boards agree that lessors should continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements (Type A leases) or sales, the balance sheet should reflect a lease receivable and the lessor’s residual interest.

With respect to the income statement, the FASB and IASB agree that an arrangement that is effectively a sale should result in recognition of a day-one profit. The FASB, however, believes that when the lessee does not obtain control of the underlying asset, the profit should be deferred and recognized over the lease term, even if the lease is classified as a Type A lease. This could occur when a lessor purchases residual value insurance—thereby transferring the risks and rewards, but not control, of the underlying asset, to the lessee.

Lessors would consider all other leases to be Type B, with income statement and balance sheet treatment similar to today’s operating leases.

For both lessees and lessors, it is critical to determine which payments should be included in the calculation of their respective assets and, in the case of a lessee, the lease liability. Previous proposals prompted significant debate. The Boards voted to include all fixed lease payments in the measurement of the lessor and lessee’s assets and the lessee’s lease liability. For variable payments (e.g., increases in rent based on CPI), the Boards voted to include rents on the basis of the rate or index at lease commencement. The FASB decided that lease payments used to measure the right-to-use asset and lease liability would not be revisited if the rate or index changes unless the lease obligation was required to be remeasured for other reasons. In contrast, the IASB decided to require remeasurement whenever a change in the reference rate results in a change in cash flows. Variable payments related to the use of the asset (e.g., percentage rent on sales) would be recognized as incurred. Lessors should not reassess variable lease payments.
**Transition**

.12 The 2013 Exposure Draft proposed a requirement to apply either a full retrospective transition approach, or to a modified approach, for lessors and lessees. In their February 2015 meeting, the FASB voted against full retrospective transition, in favor of retaining only a modified retrospective approach. The IASB elected to retain both full retrospective and modified retrospective transition approaches for lessees. The IASB further tentatively decided to require lessors to continue to apply existing lease accounting for leases in effect at the date of initial application.

.13 Currently, the Boards expect that lessees and lessors will compute lease assets and liabilities based on the remaining payments for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements (the date of initial application). The Boards will provide transition guidance for different types of lease arrangements, and will include provisions to simplify the initial application of the standard. In some cases, these provisions are not converged.

.14 In addition, the FASB will permit a lessee to elect specified transition relief provisions. These relief provisions must be elected collectively and applied consistently. The relief would allow lessees to:

   a) not reassess whether any expired or existing contracts are, or contain, leases,

   b) not reassess the lease classification for any expired or existing leases (i.e., capital leases could be assumed to be Type A leases and operating leases Type B), and

   c) not reassess initial direct costs for any existing leases (that is, whether those costs would have qualified for capitalization under the new standard).

.15 Since the Boards voted to limit the capitalization of initial direct costs to those that would not have been incurred if the lease had not been executed, the relief described in paragraph 14c above is expected to permit continued capitalization of costs that otherwise would have been written off as part of transition.

.16 Adoption of the new Leases standard will have a significant impact on a company’s financial statements and supporting systems and controls. This will require significant effort. But it is not simply gathering the information or implementing software or processes. Companies must also consider the effort needed to weigh the benefits of the recently added transition relief options in order to develop a well thought out transition plan.

**PwC observation:**

The FASB chose not to allow prospective application, as some comment letters requested, but in allowing certain elements of relief, they provided something similar. While many lessees may have hoped the Boards would simply grandfather existing leases altogether, this was unlikely given the significance and term associated with many leases, particularly those involving real estate.

The proposed relief comes at a price. There may be times when it would be beneficial to reassess whether a lease is present. However, doing so would require a reassessment of the classification of all leases. Companies will need to consider whether the overall benefit of the relief outweighs the potential benefit of removing certain types of arrangements from being accounted for under the new guidance.
**How do key provisions compare to existing standards**

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<tr>
<td><strong>Definition of a lease</strong></td>
<td>A lease is present only when an arrangement conveys the right to “control” the use of an “identified asset.”</td>
<td>Under existing guidance, a lease is typically present—even absent control—in the event one party takes substantially all of the output over the term of the arrangement. The Boards and stakeholders seem largely satisfied with the linking of lease accounting to control over an identified asset. As such, re-deliberations focused instead on ensuring that the guidance and examples were clear to facilitate consistency across industries. The determination of whether an arrangement contains a lease will be much more important given the balance sheet implications. It will also make the allocation of contractual consideration between lease and non-lease elements a critical component of the accounting analysis for many companies.</td>
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| **Balance sheet presentation** | **Lessees:** Lessees will recognize a right-of-use asset and a lease liability for all leases, subject to limited exclusions (e.g., short-term leases).  
**Lessors:** Lessor accounting will remain substantially unchanged. | **Lessees:** Putting nearly all leases on the balance sheet is the biggest change, and one of the initial objectives of the project. Changes to certain other elements of existing lease guidance (e.g., build-to-suit guidance) will impact many lessees as well.  
During the re-deliberations, the Boards voted for a number of changes to simplify application of the standard—many of which retain principles enshrined in today’s guidance (e.g., |
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<td>determining when lessee options to continue to use the asset are included in the lease term).</td>
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<td><strong>Lessors:</strong> Due in part to recent revenue guidance, the FASB and IASB have introduced symmetry into the accounting for sale and leaseback transactions. A “failed” sale would be treated as a loan by both the lessee and lessor (i.e., the seller has not sold the asset; it has mortgaged the asset). Today a lessor would record the asset purchase irrespective of whether the lessee has a sale. A failed sale would occur if the seller has a fixed price repurchase option, or any purchase option to reacquire an asset that is unique, like real estate.</td>
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<tr>
<td>Income and expense recognition</td>
<td><strong>Lessees:</strong> The Boards have proposed a number of alternatives and ultimately have agreed to disagree – with the FASB opting to retain a dual model and the IASB electing to reflect all leases as a financing.</td>
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<td><strong>Lessees:</strong> Both the IASB and FASB opted for a dual model, with classification based on whether the lease transfers substantially all risks and rewards associated with the underlying asset.</td>
<td>Begun with the hope of a converged standard, the dissimilar approaches to lessee income statement recognition will be a significant difference between IFRS and U.S. GAAP.</td>
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<td></td>
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<td>Lessor accounting will be substantially aligned between existing U.S. GAAP and IFRS.</td>
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### Topic

**Reassessment/modification**

The Boards have limited the circumstances under which a lease must be reassessed. The FASB voted to require a lessee to remeasure variable lease liabilities (i.e., lease payments that fluctuate based on a rate or index) only when there is a change to the contractual terms or a change to the lease term (e.g., exercise of a renewal not included in the initial lease term). Any changes to the lease arrangement will require a lessee to consider whether the changes result in a new lease of an asset, or a modification of the existing arrangement, but, in either case, it would consider the effect of changes to rate or index in remeasuring the resulting asset and liability when they occur.

Otherwise, any changes in payments (e.g., due to a change index) are reflected in income or expense as they accrue.

Many respondents raised concerns about the complexity resulting from the Board’s initial proposals for periodic re-measurement of the lease liability. Recent FASB decisions appear to represent a shift back to the “set it and forget it” approach under current U.S. GAAP. This will likely simplify application.

Changes to the proposed reassessment and modification guidance under U.S. GAAP should limit the circumstances that will require lessors and lessees to reassess the lease term and remeasure lease liabilities, and should reduce difficulties of complying with the standard.

The IASB is not fully aligned with the FASB in this area – notably, the IASB will require re-measurement whenever the cash flows under the lease change.

### Likely impacts of the proposed changes

.17 Despite the understandable focus on the mechanics of transition, it is also important to consider the impact that the changes may have on customary commercial arrangements. For example, consider an arrangement involving the construction of an asset to be leased upon completion (i.e., a build-to-suit lease transaction). Under current U.S. GAAP, failure to comply with specific rules will result in the lessee reflecting the arrangement as if it were the legal owner of the lease asset during construction. Along with the asset, the lessee would need to record debt equal to the funding provided by parties other than the lessee. The prescriptive rules are not expected to be retained in the final Leases standard and, as such, may prompt lessors to require a lessee to assume additional construction risk or to have greater involvement in construction.

.18 Changes to lease accounting may also prompt lessee’s to consider the potential benefits of certain highly structured lease arrangements, such as synthetic leases. In a synthetic lease arrangement, tax ownership vests with the lessee, but under today’s guidance, the lease is classified as an operating lease in the lessee’s financial statements. In most cases, fixed rent payments are relatively low (often similar to an interest only loan), but the lessee provides a large residual value guarantee to protect the lessor from any decline in the value of the asset that might reasonably occur.
**PwC observation:**
In a typical synthetic lease under the proposed Leases guidance, the lessee could assume virtually all of the economic risks associated with ownership of the asset, but reflect only the fixed and expected payments associated with the residual as the asset value and associated debt on its balance sheet.

**What’s next**
.20 The Boards have nearly completed their re-deliberations and are working on drafting the final standard, which could differ in some respects from the tentative decisions discussed to date. The Boards have indicated that they will not issue another exposure draft and hope to issue a final standard in the second half of 2015. The Boards have not yet proposed an effective date.

**Questions?**
PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial instruments team in the National Professional Services Group (1-973-236-4000).

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We’ve Been Expecting You

FASB Finalizing Credit Impairment Guidance

by Abhineti Velanand, Anthony Mosco, and Stephen McKinney, Deloitte & Touche LLP

The FASB is currently finalizing amendments to its guidance on the impairment of financial instruments. The proposed amendments would introduce a new impairment model based on expected losses rather than incurred losses. Under this current expected credit loss (CECL) model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models used to account for debt instruments.

This Heads Up provides a comprehensive summary of the FASB’s proposed changes to the credit impairment guidance under current U.S. GAAP, which are reflected in the Board’s December 2012 proposed ASU and subsequent tentative decisions. In addition, this newsletter contains several appendixes. Appendix A compares the impairment models under current U.S. GAAP, the FASB’s tentative approach, and the IASB’s recently amended IFRS 9, respectively. Appendix B gives an overview of the existing impairment models under U.S. GAAP for loans and debt securities. Appendix C and Appendix D provide illustrative examples of how an entity might apply the CECL model to purchased credit-impaired (PCI) assets and trade receivables, respectively.

Editor’s Note: Although the FASB has completed nearly all significant redeliberations and its staff has begun drafting a final ASU, the Board has yet to discuss the effective date of its proposed amendments to the current guidance on accounting for credit losses. A final standard is likely to be issued in the second half of this year.

The CECL Model

Scope

The CECL model would apply to most debt instruments (other than those measured at fair value through net income (FVTNI)), trade receivables, lease receivables, reinsurance receivables that result from

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1. Although impairment began as a joint FASB and IASB project, constituent feedback on the boards’ “dual-measurement” approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of the July 2014 amendments to IFRS 9. For more information about the IASB’s impairment model, see Deloitte’s August 8, 2014, Heads Up.

2. Note that the proposed CECL model would replace or amend several existing U.S. GAAP impairment models. See Appendix B for a tabular summary of those models.

3. FASB Proposed Accounting Standards Update, Financial Instruments — Credit Losses.

4. Decisions are as of the FASB’s March 11, 2015, meeting. Although the Board has nearly completed its deliberations in the project, the guidance in the final ASU may differ from that in the tentative decisions as a result of changes made during the finalization process.

5. The CECL model would not apply to the following debt instruments:
   - Loans made to participants by defined contribution employee benefit plans.
   - Policy loan receivables of an insurance entity.
   - Pledge receivables (promises to give) of a not-for-profit entity.
   - Loans and receivables between entities under common control.
insurance transactions, financial guarantee contracts,6 and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model’s scope and would continue to be assessed for impairment under ASC 3207 (the FASB has proposed limited changes to the impairment model for AFS debt securities, as discussed below).

**Recognition of Expected Credit Losses**

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible would be written off in a manner consistent with existing U.S. GAAP.

**Editor’s Note:** Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided that an “entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero.”8 U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

**Measurement of Expected Credit Losses**

Under the proposed amendments, an entity’s estimate of expected credit losses represents all contractual cash flows that the entity does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it “reasonably expects that it will execute a troubled debt restructuring with the borrower.”9

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity would be able to use historical charge-off rates as a starting point in determining expected credit losses, it would have to evaluate how conditions that existed during the historical charge-off period differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

**Editor’s Note:** Measuring expected credit losses will most likely be a significant challenge for all entities, particularly financial institutions. As a result of moving to an expected loss model, entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

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6 The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.
7 For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte’s “Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”
8 Quoted text is from the FASB’s summary of tentative Board decisions reached at the joint meeting of the FASB and IASB on September 17, 2013.
9 Quoted text is from the FASB’s summary of tentative Board decisions reached at its September 3, 2014, meeting.
Unit of Account

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity’s other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

Editor’s Note: The FASB’s tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined “similar risk characteristics.” As a result, it remains to be seen whether the FASB expects an aggregation based on “similar risk characteristics” to be consistent with the existing practice of pooling PCI assets on the basis of “common risk characteristics.” Entities may need to make changes to systems and processes to capture loss data at more granular levels depending on the expectations of market participants such as standard setters, regulators, and auditors.

Practical Expedients for Measuring Expected Credit Losses

The FASB tentatively decided to permit entities to use practical expedients when measuring expected credit losses for two types of financial assets:

- **Collateral-dependent financial assets** — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset’s amortized cost and the collateral’s fair value (adjusted for selling costs, when applicable).

- **Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)** — The estimate of expected credit losses would be measured consistently with how it is measured for other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral’s fair value (adjusted for selling costs, when applicable).

Write-Offs

Under the proposed ASU, an entity would write off a financial asset if it determines that it has no reasonable expectation of future recovery. However, in light of stakeholders’ concerns that the proposed requirement could conflict with regulatory guidance and may result in entities’ recognizing write-offs significantly later than under current practice, the FASB tentatively agreed to retain the write-off requirements in existing U.S. GAAP. That is, an entity would write off the carrying amount of a financial asset when the asset is deemed uncollectible. The Board also tentatively decided that this write-off guidance would apply to AFS debt securities.

AFS Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, during redeliberations, the FASB tentatively decided not to include AFS debt securities within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security’s cost basis).
- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.
Editor’s Note: The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an “investment is impaired if the fair value of the investment is less than its cost”) and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in other comprehensive income (OCI). However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write-down of the AFS security’s cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

- If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the entire credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
- If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The FASB’s tentative decisions to revise the impairment model in ASC 320 could result in earlier recognition of impairment.

PCI Assets

For PCI assets as defined in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of contractual cash flows not expected to be collected as an adjustment that increases the cost basis of the asset (the “gross-up” approach). After initial recognition of the PCI asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity’s estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Consequently, any subsequent changes to the entity’s estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows. See Appendix C for an illustrative example on how to apply the proposed guidance to PCI assets.

Editor’s Note: Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model’s proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. However, in a manner consistent with current practice, the CECL model precludes an entity from recognizing as interest income the discount embedded in the purchase price that is attributable to expected credit losses as of the date of acquisition.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows as a result of deterioration in the asset’s credit quality since origination. Under the FASB’s tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

10 The proposed ASU defines PCI assets as “[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination.”
Certain Beneficial Interests Within the Scope of ASC 325-40

The FASB tentatively decided that an impairment allowance for “purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows” should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of contractual cash flows not expected to be collected). In addition, the FASB indicated that “changes in expected cash flows due to factors other than credit should be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would not be included in interest income).”\(^{11}\)

Editor’s Note: Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Modified Financial Assets

In a manner consistent with the proposed ASU, the FASB decided not to comprehensively reconsider the accounting for modifications during redeliberations (e.g., when a modification results in derecognition or what constitutes a troubled debt restructuring (TDR)). However, the Board affirmed its previous decision that the CECL model would apply to modified debt instruments.

For non-TDR modifications that do not result in derecognition, an entity would measure expected credit losses on the basis of the cash flows expected after the modification, discounted at the post-modification effective interest rate. However, as stated in the proposed ASU, when an entity executes a TDR, “the cost basis of the modified asset shall be adjusted . . . so that the effective interest rate on the modified asset continues to be the original effective rate, given the new series of contractual cash flows. The basis adjustment . . . would be determined as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate).” The basis adjustment that reflects a decrease in cash flows post-modification would be recognized as a credit loss with a corresponding reduction to the amortized cost basis of the instrument. The basis adjustment that reflects an increase in cash flows post-modification would be recognized as an increase to the instrument’s amortized cost basis with a corresponding increase in the allowance for expected credit losses.

Loan Commitments

Off-balance-sheet arrangements such as commitments to extend credit, guarantees, and standby letters of credit that are not considered derivatives under the guidance in ASC 815 are subject to credit risk and are therefore within the scope of the CECL model. In a manner consistent with the proposed ASU, the FASB tentatively decided that the estimate of expected credit losses on the funded portion of a loan commitment should be determined similarly to how the estimate is determined for other loans. For an unfunded portion of a loan commitment, the Board tentatively decided to retain the guidance in the proposed ASU that would require an entity to “estimate [expected] credit losses over the full contractual period over which the entity is exposed to credit risk [under an unconditional] present legal obligation to extend credit.” Such an estimate would take into account both the likelihood that funding will occur and the expected credit losses on commitments to be funded.

Editor’s Note: An entity’s estimate of expected credit losses on unfunded loan commitments (e.g., credit card receivables) will most likely depend on (1) whether the entity has the unconditional ability to cancel the commitment to extend credit and, if so, (2) the time it takes for the cancellation to become effective.

\(^{11}\) Quoted text is from the FASB’s summary of tentative Board decisions reached at its June 11, 2014, meeting.
Disclosures

Many of the disclosures that would be required under the proposed ASU are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities would be required to disclose information related to:

- Credit quality.
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

In addition, the FASB affirmed the provision in the proposed ASU that would require an entity to provide a rollforward of its allowance for expected credit losses for assets measured at amortized cost and AFS debt securities. However, in a change from the proposed ASU, an entity would not be required to provide rollforward disclosures of the amortized cost balances of its debt instruments. Instead, an entity would be required to disclose credit-quality indicators for each asset class, disaggregated by vintage, for a period not to exceed five years (although upon transition, the entity would be required to provide this disclosure only for the current and prior-year amortized cost balances). The disclosure would be required for annual and interim periods and would not be required for an entity’s revolving lines of credit.

Editor’s Note: The FASB’s decision not to require the amortized cost rollforward disclosure is in response to the concerns raised by financial statement preparers about the operational challenges in providing such information. The FASB believes that disclosing credit-quality information disaggregated by asset class and by vintage would be operationally easier for financial statement preparers and would provide financial statement users with information similar to that provided in a rollforward of the amortized cost balance. Because the FASB’s tentative decision to require this new disclosure has not been exposed for public comment, the Board directed its staff to conduct significant outreach activities to obtain feedback from financial statement users, preparers, and other stakeholders on the proposed requirement.

Transition

Approach

For most debt instruments, the amendments would require entities to record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). However, the Board tentatively decided on the following instrument-specific transition provisions:

- **Other-than-temporarily impaired debt securities** — An entity would be required to apply (1) the CECL model prospectively to HTM debt securities and (2) the changes to ASC 320 prospectively to AFS debt securities. As a result, previous write-downs of a debt security’s amortized cost basis would not be reversed; rather, only changes in the estimate of expected cash flows of the debt security occurring on or after the effective date of the guidance would be reflected as an allowance for credit losses. Upon adoption of the new guidance, any impairment previously recognized in OCI would be accounted for as a prospective adjustment to the accretible yield of the debt instrument.

- **PCI assets** — An entity would be required to apply the changes to PCI assets prospectively. That is, the change in the definition of a PCI asset would apply only to assets acquired on or after the effective date of the guidance. For debt instruments accounted for under ASC 310-30, an entity would apply the gross-up approach as of the transition date (i.e., establish an allowance for expected credit losses with a corresponding adjustment to the debt instrument’s cost basis).

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12 FASB Accounting Standards Update No. 2010-20, Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses.
13 Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.
In addition, any post-adoption changes in the entity’s estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement as impairment expense (or reduction of expense). Accordingly, the yield on a PCI asset as of the date of adoption would be “locked” and would not be affected by subsequent changes in the entity’s estimate of expected credit losses.

- *Certain beneficial interests within the scope of ASC 325-40* — Entities holding such interests would need to comply with the same transition requirements as those that apply to PCI assets.

**Disclosures**

The FASB tentatively decided to retain the following transition disclosure guidance in ASC 825-15-65-1(d) and 65-1(e) of the proposed ASU:

- d. An entity shall provide the following disclosures in the period that the entity adopts the new guidance:
  1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
  2. The method of applying the change.
  3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
  4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.

- e. An entity that issues interim financial statements shall provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statement of the period of the change.

**Next Steps**

An effective date for the final guidance has not yet been proposed but will be determined at a future FASB meeting. The FASB directed its staff to prepare a draft of the final ASU for distribution to stakeholders (including financial statement users, preparers, and auditors) to obtain feedback on the proposed amendments (“fatal flaw review”).
# Appendix A — Comparison of Impairment Models

The table below compares the impairment models under current U.S. GAAP, the FASB’s tentative approach, and IFRS 9 (2014), respectively.

<table>
<thead>
<tr>
<th>Subject</th>
<th>Current U.S. GAAP</th>
<th>FASB’s Tentative Approach</th>
<th>IFRS 9 (2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope</strong></td>
<td>Applicable to:</td>
<td>Applicable to:</td>
<td>Applicable to:</td>
</tr>
<tr>
<td>• Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment.</td>
<td>Most debt instruments (other than those measured at FVTNI).</td>
<td>• Financial assets measured at amortized cost.</td>
<td></td>
</tr>
<tr>
<td>• Loans identified for individual evaluation.</td>
<td>• Lease receivables.</td>
<td>• Financial assets mandatorily measured at fair value through OCI.</td>
<td></td>
</tr>
<tr>
<td>• Loans acquired with deteriorated credit quality.</td>
<td>• Reinsurance receivables from insurance transactions.</td>
<td>• Loan commitments.</td>
<td>Financial guarantee contracts to which IFRS 9 applies (except for those measured at FVTPL).</td>
</tr>
<tr>
<td>• Debt securities (including beneficial interests in securitized financial assets).</td>
<td>• Financial guarantee contracts.</td>
<td>• Lease receivables within the scope of IAS 17.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Loan commitments.</td>
<td>• Contract assets within the scope of IFRS 15.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>AFS debt securities are excluded.</td>
<td></td>
</tr>
<tr>
<td><strong>Recognition threshold</strong></td>
<td>Depending on the nature of the financial asset, credit losses must be either probably or other-than-temporary before recognition.</td>
<td>None. Impairment is based on expected (rather than incurred) credit losses.</td>
<td>None. Impairment is based on expected (rather than incurred) credit losses.</td>
</tr>
<tr>
<td><strong>Measurement</strong></td>
<td>Varies depending on the nature of the financial asset and unit of account.</td>
<td>Single-measurement approach: current expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect).</td>
<td>Dual-measurement approach:</td>
</tr>
<tr>
<td></td>
<td>Approaches used in practice include:</td>
<td></td>
<td>• For assets in the first category, 12-month expected credit losses.</td>
</tr>
<tr>
<td></td>
<td>• Fair value measurement.</td>
<td></td>
<td>• For assets in the second category, lifetime expected credit losses.</td>
</tr>
<tr>
<td></td>
<td>• Present value of expected cash flows.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Fair value of underlying collateral.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Transfer criteria between</strong></td>
<td>Not applicable under existing U.S. GAAP models.</td>
<td>Not applicable under CECL model. Only one measurement category.</td>
<td>Transfer to lifetime expected credit losses when there has been significant deterioration in credit quality since initial recognition unless credit risk is low. Transfer back to 12-month expected credit losses when transfer criteria are no longer satisfied.</td>
</tr>
<tr>
<td><strong>measurement categories</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Trade receivables</strong></td>
<td>No specific guidance or applicable simplified approach.</td>
<td>No specific guidance or applicable simplified approach.</td>
<td>For trade receivables with a significant financing component, the three-bucket impairment model or a simplified model with an allowance of lifetime expected losses could be used.</td>
</tr>
<tr>
<td><strong>PCI assets</strong></td>
<td>Credit impairment is recognized when, on the basis of current information and events, it is probable that an investor will be unable to collect (1) all cash flows expected at acquisition plus (2) additional cash flows expected to be collected that arise from changes in post-acquisition estimates. Significant increases in the estimate of expected cash flows expected to be collected at acquisition are recognized as prospective yield adjustments.</td>
<td>The allowance for PCI assets is the current expected credit losses. Interest income recognition is based on purchase price plus the initial allowance accruing to the contractual cash flows. The non-credit-related discount or premium that results from acquiring a pool of PCI assets is allocated to each individual financial asset.</td>
<td>The allowance for PCI assets is based on the cumulative change (from the original expectation at acquisition) in lifetime expected credit losses. Interest income recognition is based on applying the credit-adjusted effective interest rate to the amortized cost of the financial asset (rather than contractual cash flows).</td>
</tr>
</tbody>
</table>

1. IAS 17, Leases.
2. IFRS 15, Revenue From Contracts With Customers.
<table>
<thead>
<tr>
<th>Subject</th>
<th>Current U.S. GAAP</th>
<th>FASB’s Tentative Approach</th>
<th>IFRS 9 (2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonaccrual accounting</td>
<td>No applicable guidance.</td>
<td>No applicable guidance.</td>
<td>IFRSs do not permit nonaccrual of interest. However, for assets that have become credit-impaired, interest income is based on the net carrying amount of the credit-impaired financial asset.</td>
</tr>
<tr>
<td>Write-offs</td>
<td>An entity writes off a financial asset in the period in which the financial asset is deemed <em>uncollectible</em>.</td>
<td>Same as under current U.S. GAAP.</td>
<td>An entity writes off the carrying amount of a financial asset if it ultimately determines that it has no reasonable expectation of future recovery.</td>
</tr>
</tbody>
</table>
## Appendix B — Impairment Models Under U.S. GAAP

The table below highlights several impairment models under current U.S. GAAP for loans and debt securities.

<table>
<thead>
<tr>
<th>Guidance</th>
<th>Scope</th>
<th>Measurement Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 450-20</td>
<td>Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment.</td>
<td>All probable and reasonably estimable losses.</td>
</tr>
<tr>
<td>ASC 310-10-35</td>
<td>Loans that are identified for individual evaluation.</td>
<td>If it is probable that all of the contractual cash flows will not be collected, the difference between the carrying amount and the present value of the expected future cash flows discounted at the original effective interest rate. Certain practical expedients exist.</td>
</tr>
<tr>
<td>ASC 310-30</td>
<td>Loans acquired with deteriorated credit quality.</td>
<td>See ASC 310-10-35 or ASC 450-20, as applicable (as discussed in ASC 310-30-35-10). Or, for a loan accounted for as a debt security, see ASC 320-10-35 (as discussed in ASC 310-30-35-8). Recoveries (i.e., reversals of impairments) are not permitted for a loan accounted for as a debt security.</td>
</tr>
<tr>
<td>ASC 320-10-35</td>
<td>Debt securities (including beneficial interests in securitized financial assets).</td>
<td>If the investor intends to sell a debt security or it is more likely than not the investor will be required to sell the security before recovery of its amortized cost basis, impairment is deemed to be other than temporary and the difference between the amortized cost and fair value of the security is recognized in earnings. However if (1) the investor does not intend to sell, (2) it is not more likely than not that the investor will be required to sell the security before recovery, and (3) the investor does not expect to recover the entire cost basis of the security, the security is other than temporarily impaired and only the credit-related component of the impairment loss is recognized in earnings, and the noncredit portion is recorded in OCI. Credit losses might be measured in accordance with ASC 310-10-35, ASC 325-40, or ASC 310-30 depending on the circumstances. Recoveries are not permitted for debt securities.</td>
</tr>
<tr>
<td>ASC 325-40-15</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The example below, which is reproduced from ASC 825-15-55-40 through 55-42 of the proposed ASU, illustrates the application of the proposed guidance to PCI assets.

Entity E is a bank that records [PCI] assets in its existing systems by recognizing the amortized cost of the asset, at acquisition, as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. The difference between amortized cost and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the asset is accreted from this amortized cost to the contractual cash flows without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition.

Assume that Entity E pays $750,000 for a debt instrument with a par amount of $1,000,000. The instrument is classified at amortized cost. At the time of purchase, the expected credit loss embedded in the purchase price is $175,000. At that date of acquisition, the statement of financial position would reflect a financial asset carrying value of $925,000 (that is, par less the non-credit-related discount) and an associated allowance for expected credit losses of $175,000. The acquisition-date journal entry is as follows.

<table>
<thead>
<tr>
<th>Loan — par amount</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan — noncredit discount</td>
<td>$75,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>175,000</td>
</tr>
<tr>
<td>Cash</td>
<td>750,000</td>
</tr>
</tbody>
</table>

Subsequently, the $75,000 noncredit discount would be accreted into interest income over the life of the debt instrument . . . . The $175,000 allowance for expected credit losses would be updated in subsequent periods . . . , with changes in the allowance for expected credit losses reflected immediately in the statement of financial performance as a provision for credit losses.
Appendix D — Application of the CECL Model to Trade Receivables

The CECL model would apply to trade receivables that result from revenue transactions within the scope of ASC 605 (or ASC 606, if adopted). The example below, which is reproduced from ASC 825-15-55-37 and 55-38 of the proposed ASU, illustrates how an entity would apply the proposed guidance to trade receivables by using a provision matrix.

Entity D manufactures and sells toys to a broad range of customers, primarily retail toy stores. Customers typically are provided payment terms of 90 days with a 2 percent discount if paid within 60 days. The entity has tracked historical loss experience for its trade receivables over the past five years and calculated the following historical loss experience:

- 0.3 percent for receivables that are current
- 8 percent for receivables that are 1–30 days past due
- 26 percent for receivables that are 31–60 days past due
- 58 percent for receivables that are 61–90 days past due
- 82 percent for receivables that are more than 90 days past due.

Entity D believes that this historical loss experience is consistent with what will be experienced for financial assets held at the reporting date because the composition of the receivables at the reporting date is consistent with that used in developing the historical statistics (that is, the shared risk characteristics of its customers has not changed significantly over time) and the economic conditions in which the historical statistics were calculated generally are consistent with the economic conditions expected over the remaining lives of the receivables.

At the reporting date, Entity D develops the following provision matrix to estimate current expected credit losses:

<table>
<thead>
<tr>
<th>Past-Due Status</th>
<th>Carrying Value</th>
<th>Loss Rate</th>
<th>Expected Credit Loss Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$ 5,984,698</td>
<td>0.3%</td>
<td>$ 17,954</td>
</tr>
<tr>
<td>1–30 days past due</td>
<td>8,272</td>
<td>8%</td>
<td>662</td>
</tr>
<tr>
<td>31–60 days past due</td>
<td>2,882</td>
<td>26%</td>
<td>749</td>
</tr>
<tr>
<td>61–90 days past due</td>
<td>842</td>
<td>58%</td>
<td>488</td>
</tr>
<tr>
<td>More than 90 days past due</td>
<td>1,100</td>
<td>82%</td>
<td>902</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 5,997,794</strong></td>
<td></td>
<td><strong>$ 20,755</strong></td>
</tr>
</tbody>
</table>

**Editor’s Note:** The proposed ASU’s example highlights that application of the CECL model to trade receivables through the use of a provision matrix may not differ significantly from an entity’s current methods for determining the allowance for doubtful accounts. However, the example illustrates that moving to an expected loss model would require entities to consider the following when using a provision matrix to estimate credit losses on trade receivables:

- Under the CECL model, an entity would be required to consider whether expected credit losses should be recognized for trade receivables that are considered “current” (i.e., not past due). In the example above, a loss rate of 0.3 percent is applied to the trade receivables that are classified as current.
- When using historical loss rates in a provision matrix, an entity would be required to consider whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future).
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Classification and measurement of financial instruments – What to expect

At a glance

The FASB has substantially completed deliberations on its financial instruments—classification and measurement project. The new standard, expected to be issued later this year, makes only targeted changes to current GAAP, with the most significant change related to investments in equity instruments. Most of those investments will be required to be measured at fair value, with subsequent changes in fair value recognized in net income. No significant changes are expected to the classification and measurement guidance for investments in loans and debt securities.

The issuance date of the final standard will partly depend on whether the FASB chooses to align the effective date of the classification and measurement project with the effective date of the still to be completed impairment project.

In addition to the expected final guidance on classification and measurement, the FASB has just issued an exposure draft of proposed disclosures for hybrid financial instruments with bifurcated embedded derivatives.

Background

.1 The classification and measurement project is one component of the FASB’s financial instruments project. The project started as a joint project with the IASB, with an objective of improving the decision usefulness of financial statements by simplifying and harmonizing the accounting for financial instruments.

.2 The FASB’s most recent exposure draft, issued in February 2013, proposed significant changes to current U.S. GAAP guidance. As a result of significant negative feedback, particularly with respect to the “solely payments of principal and interest” criterion for classifying and measuring financial assets, the FASB decided to abandon that approach and instead pursue targeted amendments to current U.S. GAAP. As a result, convergence with the IASB will not be achieved.

Key provisions

.3 The decisions reached to date on the classification and measurement project are expected to impact the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB is expected to provide clarifying guidance for deferred tax assets resulting from unrealized losses on available-for-sale debt securities.
This *In depth* summarizes the FASB’s tentative decisions to date on the classification and measurement project.

**Equity investments**

All equity investments in unconsolidated entities that are not accounted for using the equity method of accounting will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification for equity securities with readily determinable fair values.

**PwC observation:**
Eliminating the ability to record marketable equity securities (i.e., those with a readily determinable fair value) at fair value through other comprehensive income will increase earnings volatility for many companies. The FASB believes that fair value through earnings is the most appropriate measurement basis for equity investments not accounted for under the equity method, because their value will generally be realized through sale.

Some exceptions are expected to the fair value through earnings measurement requirement. Most notably, certain companies will be able to elect a practicability exception when measuring investments in certain equity securities that do not have a readily determinable fair value. If the practicability exception is elected, companies will record investments at cost, less impairment, and subsequently adjust for observable price changes (i.e., prices in orderly transactions for the identical investment or similar investment of the same issuer). This exception is for equity investments that do not qualify for the practical expedient in ASC 820-10-35-59, *Fair Value Measurement*, which allows the use of net asset value per share once certain conditions are met.

Once a reporting entity elects the practicability exception, it will need to perform an ongoing assessment of the investment to determine if an impairment has occurred. An impairment charge for the difference between the carrying amount and the fair value would be recognized in earnings when, based upon an assessment of various impairment indicators, the fair value of the investment is less than its carrying amount. There will be no other-than-temporary impairment model, and the recognition of an impairment will be considered a basis adjustment (i.e., not as a valuation allowance). Therefore, if there is a subsequent recovery in fair value, a previous impairment charge could not be reversed. However, the carrying amount of the investment would still need to be adjusted for any observable positive or negative price changes.

**PwC observation:**
Although nonmarketable equity securities (i.e., those without a readily determinable fair value) are measured at cost, less impairment today, adjusting them to reflect any observable price changes under the practicability exception will increase the potential for earnings volatility. Nonetheless, companies will likely find the practicability exception helpful, as it will alleviate the challenges associated with gathering information necessary to determine fair value at every reporting date. The FASB’s discussions suggest that companies are not expected to perform an exhaustive search to identify observable prices under this exception. Instead, we expect that companies would only need to identify and use observable prices that they can reasonably be expected to know or that they can readily obtain (such as when there is a subsequent round of financing). The FASB is expected to clarify this point, and the concept of a “similar investment of the same issuer” in its implementation guidance.

Investment companies and broker dealers will not be permitted to elect the proposed practicability exception for investments in nonmarketable equity securities.
Equity investments classification

Loans and debt securities

Financial liabilities and the fair value option
PwC observation:

Although the FASB questioned the conceptual merit of assuming the change in fair value above a base market risk is attributable to a change in an entity’s own credit risk (i.e., a portion of that change may be attributable to other factors such as liquidity, etc.), it ultimately agreed to allow this approach to ease the burden on preparers.

The requirement to record the change in fair value due to an entity’s own credit risk in other comprehensive income represents a change from current U.S. GAAP and applies solely to financial liabilities that are being accounted for in accordance with the fair value option. This change does not impact other financial liabilities that are required to be measured at fair value with changes in fair value recognized in earnings, such as derivative liabilities.

.12 No significant changes are expected to the classification and measurement of liabilities that are not subject to a fair value option election.

Deferred tax

.13 Unrealized losses on available-for-sale debt securities are recognized in other comprehensive income and typically give rise to deferred tax assets. A valuation allowance is required to the extent any deferred tax asset is not realizable.

.14 The FASB is expected to require that these deferred tax assets be evaluated for realizability in combination with other deferred tax assets of an entity.

Presentation

.15 All companies will continue to follow the statement of financial position presentation requirements for financial instruments in current U.S. GAAP. However, the FASB decided that only public business entities will be required to present fair value information for financial assets and liabilities measured at amortized cost. This information can be presented either parenthetically on the face of the balance sheet or in the notes to the financial statements, and will not apply to receivables and payables due within one year and demand deposit liabilities. The board concluded that the benefit to financial statement users of presenting such information did not justify the likely cost for nonpublic entities (i.e., entities other than public business entities) to obtain the necessary valuations.

.16 Public business entities will be required to provide fair value information for financial assets and liabilities based upon the exit price notion in ASC 820, *Fair Value Measurement*. This may represent a change in practice for some entities that had previously provided fair value information for loans using an entry price based upon their interpretation of the illustrative examples in ASC 825, *Financial Instruments*. 
PwC observation:

The new guidance will remove the current financial statement classification categories for equity securities (i.e., trading and available for sale). This could impact a reporting entity’s process for determining the appropriate classification for cash flows arising from equity security transactions in the statement of cash flows. Currently, cash flows from purchases and sales of investments accounted for as trading securities under ASC 320, Investments – Debt and Equity Securities are classified as operating activities, whereas cash flows related to purchases and sales of investments accounted for as available-for-sale equity securities are classified as investing activities. However, because equity securities will no longer be classified as either trading or available for sale, companies may have to update their policies and procedures and related internal controls to determine how cash flows from equity securities should be classified for purposes of preparing the statement of cash flows.

Disclosures

.17 The new guidance will require new disclosures for financial instruments in addition to the disclosures required by current U.S. GAAP. These expected incremental disclosures are listed in the Appendix.

.18 Separately, on February 24, the FASB issued a proposed Accounting Standards Update (ASU) on hybrid financial instruments containing embedded derivatives for public comment. The proposed ASU would require certain additional disclosures by entities with hybrid financial instruments containing embedded derivatives that require bifurcation. The perceived need for these disclosures is a consequence of the FASB’s decision to retain the current guidance for bifurcating certain embedded derivatives from hybrid financial instruments. The intent of the proposed disclosures is to allow users to better understand the linkage between bifurcated embedded derivatives and the related host contracts. The proposed incremental disclosures are listed in the Appendix.

Transition

.19 The new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, the practicability exception for equity securities without a readily determinable fair value will be available prospectively to eliminate the need for preparers to retrospectively identify any observable price changes that may have occurred in prior periods.

What’s next

.20 The FASB will discuss the effective date for its classification and measurement standard at a future meeting. The FASB has yet to decide whether to align the effective date with that of the anticipated impairment standard.

.21 Comments on the FASB’s proposed ASU on hybrid financial instruments are due by April 30, 2015. The Board hopes to issue a final standard by the end of June, 2015.
## Appendix – New disclosure requirements

### Classification and measurement project

<table>
<thead>
<tr>
<th>Required disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>All financial assets and liabilities</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial instruments not recognized at fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Public business entities are required to disclose fair value (based upon an exit price as defined in ASC 820, <em>Fair Value Measurement</em>) either on the face of the balance sheet or in the notes (except for demand deposit liabilities and receivables and payables due within one year)</td>
</tr>
<tr>
<td>• The fair value hierarchy level within which the fair value measurement is categorized (Levels 1, 2, or 3)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Practicability exception for equity investments without readily determinable fair values</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The carrying amount of investments without readily determinable fair values measured using the practicability exception</td>
</tr>
<tr>
<td>• The total amount of adjustments resulting from impairment</td>
</tr>
<tr>
<td>• The total amount of adjustments resulting from changes in observable prices</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transition requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle</td>
</tr>
<tr>
<td>• The method of applying the adoption</td>
</tr>
<tr>
<td>• The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective</td>
</tr>
<tr>
<td>• The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first reporting period in which the guidance is effective</td>
</tr>
</tbody>
</table>

### Hybrid financial instruments containing embedded derivatives

<table>
<thead>
<tr>
<th>Proposed disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embedded derivatives that have been bifurcated and accounted for separately from the host contract</td>
</tr>
<tr>
<td>• Carrying amount of the host contract and embedded derivative</td>
</tr>
<tr>
<td>• Measurement attribute of the host contract (e.g., fair value, amortized cost) and embedded derivative (i.e., fair value)</td>
</tr>
<tr>
<td>• Line item(s) within the balance sheet and income statement in which any embedded derivatives and related host contract are presented</td>
</tr>
</tbody>
</table>

---

1 These disclosures are incremental to those currently required under U.S. GAAP
PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

**Questions?**

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FASB proposes a one-year deferral of the new revenue standard

What you need to know

• The FASB proposed a one-year delay in the effective date of the new revenue recognition standard for both public and nonpublic entities reporting under US GAAP.
• Early adoption would be permitted for all entities but not before the original public entity effective date.
• The IASB also has agreed to propose a one-year delay in the effective date of its new revenue recognition standard.
• Comments on the FASB proposal are due by 29 May 2015.

Overview

The Financial Accounting Standards Board (FASB or Board) today issued an exposure draft (ED) of a proposed Accounting Standards Update (ASU) that would delay by one year the effective date of its new revenue recognition standard for public and nonpublic entities reporting under US GAAP.

Under the proposal, the standard would be effective for public entities for annual reporting periods beginning after 15 December 2017 and interim periods therein. Nonpublic entities would be required to adopt the standard for annual reporting periods beginning after 15 December 2018, and interim periods within annual reporting periods beginning after 15 December 2019.
The proposal would permit both public and nonpublic entities to adopt the standard as early as the original public entity effective date (i.e., annual reporting periods beginning after 15 December 2016 and interim periods therein). Early adoption prior to that date would not be permitted.

The International Accounting Standards Board (the IASB), which developed its new revenue standard jointly with the FASB, decided at a meeting on 28 April 2015 to also propose a one-year deferral, which would keep the new standards’ effective dates converged under IFRS and US GAAP. The IASB is expected to issue an exposure draft proposing the delay soon.

Background

The FASB launched a research project in October 2014 to determine whether to propose delaying the effective date of the new revenue standard. Preparers had told the FASB in outreach as well as unsolicited comment letters that implementing the new standard would be challenging, and the FASB and the IASB are considering amending the new standards to address issues raised through their Joint Transition Resource Group for Revenue Recognition.

The FASB decided to propose a delay in the effective date, in part, to address concerns raised about the time needed to implement changes to information technology systems and internal controls and uncertainties involving issues being discussed by various implementation groups. At a meeting earlier this month, some FASB members favored proposing a two-year delay in the effective date, but a majority of the Board’s members voted to propose a one-year delay. The ED asks respondents to comment on whether the FASB also should give entities the option to delay adoption for two years if they retrospectively apply the standard to each reporting period presented.

Proposed effective dates

This table illustrates the new effective dates the FASB proposed for public and nonpublic entities with calendar year ends.

<table>
<thead>
<tr>
<th>Year end</th>
<th>Mandatory adoption date</th>
<th>Early adoption date(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public entities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 December</td>
<td>1 January 2018 effective date, first present in 31 March 2018 Form 10-Q</td>
<td>1 January 2017 effective date, first present in 31 March 2017 Form 10-Q</td>
</tr>
<tr>
<td><strong>Nonpublic entities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 December</td>
<td>1 January 2019 effective date, first present in the financial statements for the year ended 31 December 2019</td>
<td>1 January 2017 effective date, first present in 31 March 2017 interim financial statements or first present in the financial statements for the year ended 31 December 2017 OR 1 January 2018 effective date, first present in 31 March 2018 interim financial statements or first present in the financial statements for the year ended 31 December 2018 OR 1 January 2019 effective date, first present in 31 March 2019 interim financial statements</td>
</tr>
</tbody>
</table>
How we see it

It is important for companies to continue to make progress with implementation plans so they can make an orderly transition to the new standard. Stakeholders with concerns about the proposed one-year deferral should submit comments to the FASB.

A one-year delay would help companies that need extra time to implement the standard appropriately. While a delay could result in a lack of comparability between the financial statements of companies that early adopt and those that don’t, many believe that, on balance, a one-year delay is appropriate to promote an effective implementation.

Endnote:

1 The term public entities refers to public business entities, not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market and employee benefit plans that file or furnish financial statements with or to the Securities and Exchange Commission.
The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) created the Joint Transition Resource Group for Revenue Recognition (TRG) to help them determine whether more guidance is needed on their new revenue standards. TRG members include financial statement preparers, auditors and users from a variety of industries, countries and public and private entities. This table summarizes the issues on which members of the TRG generally agreed at meetings this year and in 2014.

While the unofficial views of the members of the TRG are non-authoritative, they represent the latest thinking on each topic, and entities should consider them as they implement the new standards. Our summary, which is organized both by step in the new revenue model and by topic, is not intended to replace any summaries provided by the TRG or the Boards. We will update this table periodically. For more information about these issues and issues the TRG discussed but did not reach general agreement on, see our To the Point publications on TRG meetings on EY AccountingLink.

<table>
<thead>
<tr>
<th>Step 1: Identify the contract(s) with a customer</th>
<th>Collectibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under the new standards, collectibility refers to the customer’s ability and intent to pay the amount of consideration to which the entity expects to be entitled. The Boards concluded that assessing a customer’s credit risk is an important part of determining whether a contract, as defined by the standards, exists. If an arrangement does not meet the collectibility criterion (or any of the other criteria to be considered a contract under the standards), an entity should recognize nonrefundable consideration received as revenue only when one of these two events has occurred: (1) The entity has completed performance and received substantially all consideration or (2) the contract has been terminated.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Questions raised</th>
<th>General agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>How should an entity assess collectibility for a portfolio of contracts? [26 January 2015]</td>
<td>TRG members agreed that if an entity has determined it is probable that a customer will pay amounts owed under a contract, but the entity has historical experience that it will not collect consideration from some customers within a portfolio of contracts, it would be appropriate for the entity to record revenue for the contract in full and separately evaluate the corresponding contract asset or receivable for impairment. Some TRG members cautioned that the analysis to determine when to record bad debt expense for a contract in the same period when revenue is recognized (instead of reducing revenue for an anticipated price concession) will require judgment.</td>
</tr>
</tbody>
</table>

<p>| When should an entity reassess collectibility? [26 January 2015] | The standards require an entity to evaluate at contract inception (and when significant facts and circumstances change) whether it is probable that it will collect the consideration to which it expects to be entitled (i.e., the transaction price, not the stated contract price). TRG members agreed that entities would need to exercise judgment to determine whether changes in the facts and circumstances are significant enough to indicate that a contract no longer exists. |</p>
<table>
<thead>
<tr>
<th>How should an entity assess whether a contract includes a price concession? [26 January 2015]</th>
<th>The Boards have indicated that an entity’s belief that it will receive partial payment for performance may be sufficient evidence that an arrangement meets the definition of a contract (and that the expected shortfall of consideration is more akin to a price concession). TRG members agreed that entities will need to exercise judgment. They also acknowledged that it may be difficult in some cases to distinguish between price concessions, bad debt and a lack of sufficient commercial substance to be considered a contract.</th>
</tr>
</thead>
<tbody>
<tr>
<td>While this topic wasn’t on the TRG agenda, TRG members questioned whether the Boards intended to indefinitely delay recognition of nonrefundable cash consideration received in a number of situations (e.g., a month-to-month service arrangement when the entity continues to perform). [26 January 2015]</td>
<td>TRG members raised this issue in their discussion and said the Boards’ intent wasn’t clear. <strong>Boards’ response:</strong> In March 2015, the FASB voted to propose amending its standard to clarify that a contract would be terminated when an entity has the ability to stop transferring goods or providing services and has actually done so. The FASB also voted to propose amending its standard to refine the guidance in the Step 1 collectibility threshold and/or add or amend examples to clarify that an entity should consider the probability of collecting the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer rather than the total amount promised. The IASB staff will perform more research on this topic.</td>
</tr>
</tbody>
</table>

**Contract enforceability and termination clauses**

Under the new standards, termination clauses are an important consideration when determining whether both parties are committed to perform under a contract and, consequently, whether a contract, as defined by the standards, exists.

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<thead>
<tr>
<th>Questions raised</th>
<th>General agreement</th>
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<tbody>
<tr>
<td>How should termination clauses be evaluated in determining the duration of a contract (i.e., the contractual period)? [31 October 2014]</td>
<td>TRG members generally concurred with the conclusions reached in the examples in the staffs’ issue paper on this topic. For example, if a contract with a stated contractual term can be terminated by either party for no consideration at any time, TRG members generally agreed that the arrangement should be treated as a month-to-month contract, regardless of its stated contractual term. TRG members also agreed that when a contract includes a substantive termination payment, the duration of the contract should equal the stated contractual term (or to the date when a termination payment would not be due).</td>
</tr>
</tbody>
</table>
### Step 2: Identify the performance obligations in the contract

**Identification of performance obligations**

To apply the new guidance, an entity must identify the promised goods and services within the contract and determine which of those goods and services are distinct (i.e., performance obligations, which are the units of account).

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<thead>
<tr>
<th>Questions raised</th>
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<tbody>
<tr>
<td>Will the new standards require the identification of promised goods or services that are not identified as deliverables today? [26 January 2015]</td>
<td>Generally, no. However, entities will no longer be allowed to disregard items they deem to be perfunctory or inconsequential and will need to consider “free” goods and services. As a result, telecommunications entities will have to allocate consideration to the “free” handsets they provide. Likewise, automobile manufacturers would have to allocate consideration to “free” maintenance that is considered a marketing incentive today. <strong>Boards’ response:</strong> In February 2015, the FASB voted to propose allowing entities to disregard promises that are deemed to be immaterial in the context of the contract. The FASB’s intent is to allow entities to disregard immaterial items at the contract level and not to require that they be aggregated and assessed for materiality at the entity level. The IASB does not plan to propose a similar change.</td>
</tr>
</tbody>
</table>

**Stand-ready obligations**

The new standards note that a contract may include “a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides.”

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<tr>
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<tbody>
<tr>
<td>What is the nature of the promise in a “typical” stand-ready obligation? [26 January 2015]</td>
<td>TRG members generally agreed that the promise in a stand-ready obligation is the assurance that the customer will have access to the good or service, not the delivery of the underlying good or service. A FASB staff member said the staff does not believe that the FASB intended to change current practice under US GAAP for determining when software/technology transactions include specified upgrade rights (i.e., a separate performance obligation) or unspecified upgrade rights (i.e., a stand-ready obligation).</td>
</tr>
<tr>
<td>How should an entity measure progress toward satisfaction of a stand-ready obligation that is satisfied over time? [26 January 2015]</td>
<td>TRG members agreed that an entity should not default to a straight line revenue attribution model. However, TRG members generally agreed that if an entity expects the customer to receive and consume the benefits of its promise throughout the contract period, a time-based measure of progress (e.g., straight line) would be appropriate. A FASB staff member indicated that this may often be the case for unspecified upgrade rights. TRG members generally agreed that ratable recognition may not be appropriate if the benefits are not spread evenly over the contract period (e.g., an annual snow removal contract that provides more benefits in winter).</td>
</tr>
</tbody>
</table>
### Series of distinct goods and services

The new standards require that a series of distinct goods or services be accounted for as a single performance obligation if they are substantially the same, have the same pattern of transfer, and both of the following criteria are met: (1) each distinct good or service in the series represents a performance obligation that would be satisfied over time, and (2) the entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series. Entities will need to determine whether a single performance obligation is created in this manner to appropriately allocate variable consideration and apply the guidance on contract modifications and changes in transaction price.

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<tr>
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<tbody>
<tr>
<td>In order to apply the series guidance, must the goods or services be consecutively transferred? [30 March 2015]</td>
<td>TRG members agreed that a series of distinct goods or services need not be consecutively transferred. That is, the series guidance also must be applied when there is a gap or an overlap in an entity’s transfer of goods or services, provided that the other criteria are met. TRG members in London also noted that entities may need to carefully consider whether the series guidance applies depending on the length of the gap between an entity’s transfer of goods or services.</td>
</tr>
<tr>
<td>In order to apply the series guidance, does the accounting result need to be the same as if the underlying distinct goods and services were accounted for as separate performance obligations? [30 March 2015]</td>
<td>TRG members agreed that the accounting result does not need to be the same and that an entity is not required to prove that the result would be the same as if the goods and services were accounted for as separate performance obligations.</td>
</tr>
</tbody>
</table>

### Gross versus net revenue – amounts billed to customers

Under the new standards, an entity is required to determine whether the nature of its promise is to provide the specified goods or services itself (i.e., the entity is a principal) or to arrange for another party to provide those goods or services (i.e., the entity is an agent). Further, the standards require that any “amounts collected on behalf of third parties (for example, some sales taxes)” be excluded from the transaction price.

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<tr>
<td>How should entities determine the presentation of amounts billed to customers (e.g., shipping and handling, reimbursement of out-of-pocket expenses, taxes or other assessments) under the new standards (i.e., as revenue or as a reduction of costs)? [18 July 2014]</td>
<td>TRG members generally agreed that the standards are clear that any amounts not collected on behalf of third parties should be included in the transaction price (i.e., revenue). That is, if the amounts were incurred by the entity in fulfilling its performance obligations, the amounts should be included in the transaction price and recorded as revenue. Several TRG members noted that this would require entities to evaluate taxes collected in all jurisdictions in which they operate to determine whether a tax is levied on the entity or the customer. In addition, TRG members said an entity should apply the principal versus agent guidance when it is not clear whether the amounts are collected on behalf of third parties. This could result in amounts billed to a customer being recorded as an offset to costs incurred, even when the amounts are not collected on behalf of third parties. <strong>Boards’ response:</strong> In March 2015, the FASB voted to propose adding a practical expedient that would allow an entity to present revenue net of certain types of taxes, including sales, use, excise, value-added and franchise taxes (collectively referred to as sales taxes) with disclosure of the policy. The IASB decided that a similar expedient is not necessary.</td>
</tr>
<tr>
<td><strong>Customer options for additional goods and services</strong></td>
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<tr>
<td>The standards state that when an entity grants a customer the option to acquire additional goods or services (e.g., future sales incentives, loyalty programs, renewal options), that option is a separate performance obligation if it provides a material right to the customer.</td>
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<tr>
<td><strong>Questions raised</strong></td>
<td><strong>General agreement</strong></td>
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<tr>
<td>Should entities consider only the current transaction or should they consider past and future transactions with the same customer when determining whether an option for additional goods and services provides the customer with a material right? [31 October 2014]</td>
<td>TRG members agreed that entities should consider accumulating incentives in programs (e.g., loyalty programs) when determining whether an option represents a material right. That is, they do not believe the evaluation should be performed only in relation to the current transaction.</td>
</tr>
<tr>
<td>Is the material right evaluation solely a quantitative evaluation or should the evaluation also consider qualitative factors? [31 October 2014]</td>
<td>TRG members agreed that the evaluation should consider both quantitative and qualitative factors (e.g., what a new customer would pay for the same service, the availability and pricing of competitors’ service alternatives, whether the average customer life indicates that the fee provides an incentive for customers to remain beyond the stated contract term).</td>
</tr>
<tr>
<td>How should an entity account for the exercise of a material right? That is, should it be accounted for as a contract modification, a continuation of the existing contract or as variable consideration? [30 March 2015]</td>
<td>TRG members thought it would be reasonable for an entity to apply the guidance on contract modifications to the exercise of a material right. This conclusion primarily focuses on the definition of a contract modification (i.e., “a change in the scope or price (or both) of a contract”). However, many TRG members favored an approach that would treat the exercise of a material right as a continuation of the existing contract (and not a contract modification) because the customer decided to purchase additional goods or services that were contemplated in the original contract (and not as part of a separate and subsequent negotiation). That is, more than one interpretation would be acceptable in this instance. TRG members discussed that an entity will need to consider which approach is most appropriate depending on the facts and circumstances and consistently apply that approach to similar contracts.</td>
</tr>
<tr>
<td>Is an entity required to evaluate whether a customer option that provides a material right includes a significant financing component? If so, how should entities perform this evaluation? [30 March 2015]</td>
<td>TRG members agreed that an entity will have to evaluate whether a material right includes a significant financing component, as it would need to do for any other performance obligation. This will require judgment and consideration of the facts and circumstances. The staff paper on this question discussed a factor that could be determinative in this evaluation. The new standards state that if a customer provides advance payment for a good or service but the customer can choose when the good or service is transferred, no significant financing component exists. As a result, if the customer can choose when to exercise the option, there is likely not a significant financing component.</td>
</tr>
</tbody>
</table>
### Step 3: Determine the transaction price

#### Variable consideration

Entities will be required to constrain the amount of variable consideration included in the estimated transaction price. That is, they will have to conclude that it is probable (highly probable)\(^3\) that a significant revenue reversal will not occur in future periods before including any such amounts in the transaction price.

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<tbody>
<tr>
<td>Should the constraint on variable consideration be applied at the contract or performance obligation level? [26 January 2015]</td>
<td>TRG members agreed that the constraint should be applied at the contract level and not at the performance obligation level. That is, the significance assessment of the potential revenue reversal should contemplate the total transaction price of the contract (and not the transaction price allocated to the performance obligation).</td>
</tr>
</tbody>
</table>

#### Significant financing components

Under the new standards, an entity is required to assess whether a contract contains a significant financing component if it receives consideration more than one year before or after it transfers goods or services to the customer (e.g., the consideration is prepaid or is paid after the goods/services are provided).

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>The standards state that a significant financing component does not exist if the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than providing financing. Should this factor be broadly or narrowly applied? [30 March 2015]</td>
<td>TRG members agreed that there likely will be significant judgment involved in determining whether a significant financing component exists. TRG members agreed that the Boards did not seem to intend to imply that there is a presumption that a significant financing component exists if the cash selling price is different from the promised consideration or, conversely, that a significant financing component does not exist simply because an advance payment is received from the customer. TRG members agreed that while there may be valid non-financing reasons for advance payments, the standards do not exclude advance payments from the guidance on significant financing components. As a result, it is important that entities analyze all of the facts and circumstances in a contract.</td>
</tr>
<tr>
<td>Question</td>
<td>TRG Note</td>
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<tr>
<td>The standards state that an entity must consider the difference, if any, between the amount of promised consideration and the cash selling price of a promised good or service when determining whether a significant financing component exists in a contract. If the promised consideration is equal to the cash selling price, does a financing component exist? [30 March 2015]</td>
<td>TRG members agreed that even if the list price, cash selling price and promised consideration of a good or service are all equal, an entity should not automatically assume that a significant financing component does not exist. This would be a factor to consider but would not be determinative.</td>
</tr>
<tr>
<td>Do the standards preclude accounting for financing components that are not significant? [30 March 2015]</td>
<td>TRG members agreed that the standards will not preclude an entity from deciding to account for a financing component that is not significant. In addition, an entity electing to apply the guidance on significant financing components for an insignificant financing should be consistent in its application to all similar contracts with similar circumstances.</td>
</tr>
<tr>
<td>The standards include a practical expedient, which allows an entity to not assess a contract for a significant financing component if the period between the customer’s payment and the entity’s transfer of the goods or services is one year or less. How should entities consider whether the practical expedient applies to contracts with a single payment stream for multiple performance obligations? [30 March 2015]</td>
<td>TRG members generally agreed that entities will either apply an approach whereby any consideration received is allocated (1) to the earliest good or service delivered or (2) proportionately between the goods and services depending on the facts and circumstances. The staff paper on this topic provided an example of a telecommunications entity that enters into a two-year contract to provide a device at contract inception and related data services over the remaining term in exchange for 24 equal monthly installments. The former approach would allow the entity to apply the practical expedient because the period between transfer of the good or service and customer payment would be less than one year for both the device and the related services. The latter approach would not allow an entity to apply the practical expedient because the device would be deemed to be paid off over the full 24 months (i.e., greater than one year). The latter approach may be appropriate in circumstances similar to the staffs’ example, when the cash payment is not directly tied to a particular good or service in a contract. However, the former approach may be appropriate when the cash payment is directly tied to a particular good or service.</td>
</tr>
<tr>
<td>If a significant financing component exists in a contract, how should an entity calculate the adjustment to revenue? [30 March 2015]</td>
<td>TRG members agreed that the new revenue standards do not contain guidance on how to calculate the adjustment to the transaction price due to a financing component. A financing component will be recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). Entities should consider guidance outside the revenue standards to determine the appropriate accounting (i.e., Accounting Standards Codification (ASC) 835-30, Interest – Imputation of Interest, or IFRS 9 Financial Instruments/IAS 39 Financial Instruments: Recognition and Measurement).</td>
</tr>
<tr>
<td>How should an entity allocate a significant financing component when there are multiple performance obligations in a contract? [30 March 2015]</td>
<td>TRG members noted it may be difficult to require allocation to specific performance obligations because cash is fungible, but it may be reasonable for entities to apply other guidance in the new standards that requires variable consideration and/or discounts to be allocated to one or more (but not all) performance obligations, if certain criteria are met.</td>
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</table>
### Step 4: Allocate the transaction price to the performance obligations identified in the contract

#### Variable discounts

Under the new standards’ relative standalone selling price method, a contract’s transaction price will be allocated proportionately to all performance obligations identified in a contract, with two exceptions. The exceptions specify that variable consideration and/or discounts must be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations, if certain criteria are met. The criteria for each exception are different.

<table>
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<tr>
<td>Since some discounts also will meet the definition of variable consideration (i.e., a discount that is variable in amount and/or contingent on future events), which exception should an entity apply? [30 March 2015]</td>
<td>TRG members agreed that under the new standards, an entity will first determine whether a variable discount meets the variable consideration exception. If it does not, the entity then will consider whether it meets the discount exception. In contrast, if the discount is not variable (i.e., the dollar amount is fixed and not contingent on future events), it only should be evaluated under the discount exception.</td>
</tr>
</tbody>
</table>

### Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

#### Partial satisfaction of performance obligations prior to identifying the contract

An entity cannot begin to recognize revenue on an arrangement until it meets all five criteria to be considered a contract under the new standards, regardless of whether it has received any consideration or has begun performing under the terms of the arrangement. Further, an entity can capitalize certain fulfillment costs on specifically identified anticipated contracts, if certain criteria are met.

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<tr>
<td>Entities sometimes will begin activities on a specifically anticipated contract either (1) before agreeing to the contract with the customer or (2) before the contract satisfying the criteria to be accounted for under the standards (referred to in the staff paper as the “contract establishment date” or CED). If these activities will result in the transfer of a good or service to the customer at the CED, how should revenue for those activities be recognized at the CED? [30 March 2015]</td>
<td>TRG members agreed that if the goods or services that ultimately will be transferred meet the criteria to be recognized over time, revenue should be recognized on a cumulative catch-up basis at the CED, reflecting the performance obligation(s) that are partially or fully satisfied at that time. The cumulative catch-up method was deemed to be consistent with the overall principle of the new standards that revenue should be recognized when (or as) an entity transfers control of goods or services to a customer.</td>
</tr>
<tr>
<td>How should an entity account for fulfillment costs incurred prior to the CED that are outside the scope of another standard (e.g., ASC 330, Inventory)? [30 March 2015]</td>
<td>TRG members agreed that costs relating to pre-CED activities that relate to a good or service that will transfer to the customer at or after the CED may be capitalized as costs to fulfill a specifically anticipated contract. However, TRG members noted such costs would still need to meet the other criteria in the standards to be capitalized (e.g., they are expected to be recovered under the anticipated contract). Subsequent to capitalization, costs that relate to goods or services that are transferred to the customer at the CED should be expensed immediately. Any remaining capitalized costs would be amortized over the period that the related goods or services are transferred to the customer.</td>
</tr>
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</table>
### Other measurement and recognition topics

#### Warranties

The new standards identify two types of warranties. A warranty is a service-type warranty if the customer has the option to purchase it separately or if it provides a service to the customer beyond fixing defects that existed at the time of sale. A service-type warranty is accounted for as a performance obligation. An assurance-type warranty does not provide an additional good or service but instead is a promise to the customer that the delivered product is as specified in the contract. An assurance-type warranty is accounted for under ASC 460, *Guarantees/IAS 37 Provisions, Contingent Liabilities and Contingent Assets*.

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<tr>
<td>How should an entity evaluate whether a product warranty is a service-type warranty (i.e., a performance obligation) when it is not separately priced? [30 March 2015]</td>
<td>TRG members agreed that the evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications will require judgment and depend on the facts and circumstances. There is no bright line in the standards on what constitutes a service-type warranty beyond it being separately priced. However, the standards do include three factors that should be considered in each evaluation (i.e., whether the warranty is required by law, the length of the warranty coverage and the nature of the tasks that the entity promises to perform). Further, the FASB staff emphasized that entities should not assume that today's accounting will remain unchanged under the new standards. Entities will need to evaluate each type of warranty offered to determine the appropriate accounting.</td>
</tr>
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</table>

#### Incremental costs to obtain a contract

Under ASC 340-40, IFRS 15, the incremental cost of obtaining a contract (e.g., sales commissions) will be recognized as an asset if the entity expects to recover it.

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<tr>
<td>When should an entity capitalize commissions paid on renewal contracts and how much should they capitalize? How should an entity amortize these amounts and evaluate whether the renewals are commensurate with the initial commissions paid? Should commissions earned on contract modifications that are not treated as separate contracts be capitalized? If commissions are contingent on future events, can they be considered incremental? Can commissions subject to clawbacks and/or achieving cumulative thresholds be capitalized? Should fringe benefits on commission payments be included in the capitalized amounts? What is the pattern of amortization for a contract cost asset that relates to multiple performance obligations that are satisfied over disparate periods of time? [26 January 2015]</td>
<td>Instead of focusing on the detailed questions in the staff paper, TRG members discussed the underlying principle for capitalizing costs under the new revenue standards. The TRG members agreed that neither ASC 340-40 nor ASC 606, IFRS 15 amended current US GAAP/IFRS liability guidance. Therefore, entities should first refer to the applicable liability standard to determine when they are required to accrue for certain costs. Entities would then use the guidance in ASC 340-40/IFRS 15 to determine whether the related costs need to be capitalized. TRG members generally agreed that no changes to the guidance are necessary. They also agreed that certain aspects of the cost guidance will require entities to apply significant judgment in analyzing the facts and circumstances and determining the appropriate accounting for items such as the amortization pattern for a contract cost asset that relates to multiple performance obligations that are satisfied over different periods of time.</td>
</tr>
</tbody>
</table>
### Impairment testing of capitalized contract costs

Any costs capitalized under ASC 340-40/IFRS 15 (i.e., costs incurred in fulfilling a contract and incremental costs of obtaining a contract) are subject to an impairment assessment at the end of each reporting period. An impairment exists if the carrying amount of any asset(s) exceeds the amount of consideration the entity expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those good and services.

<table>
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<tr>
<td>Should entities include contract renewals or extensions when determining the remaining amount of consideration the entity expects to receive in order to perform an impairment test on capitalized contract costs? [18 July 2014]</td>
<td>TRG members agreed that an impairment test of capitalized contract costs should include future cash flows associated with contract renewal or extension periods. The question was raised because of an inconsistency between ASC 340-40 and ASC 606 and within IFRS 15. ASC 340-40/IFRS 15 indicates that costs capitalized under the standards could relate to goods or services to be transferred under “a specific anticipated contract” (e.g., goods or services to be provided under contract renewals and/or extensions). That guidance further states that an impairment loss should be recognized when the carrying amount of the asset exceeds the remaining amount of consideration expected to be received in exchange for the goods or services to which the asset relates, and that an entity should use the principles of ASC 606/IFRS 15 when determining the remaining transaction price. However, ASC 606-10-32-4/IFRS 15.49 states that an entity should not anticipate that the contract will be “cancelled, renewed or modified” when determining the transaction price. In some instances, excluding renewals or extensions would trigger an immediate impairment of a contract asset because the consideration an entity expects to receive would not include anticipated cash flows from contract extension or renewal periods, but the entity would have capitalized contract costs on the basis that they would be recovered over the contract extension or renewal periods.</td>
</tr>
</tbody>
</table>

### Contract assets and liabilities

The new standards are based on the notion that a contract asset or contract liability is generated when either party to a contract performs. The standards require that an entity present these contract assets or contract liabilities in the statement of financial position. When an entity satisfies a performance obligation by delivering the promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first, for example, by prepaying its promised consideration, the entity has a contract liability.

<table>
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<tr>
<td>How should an entity determine the presentation of contract assets and liabilities for contracts that contain multiple performance obligations? [31 October 2014]</td>
<td>TRG members agreed that contract assets and liabilities should be determined at the contract level and not at the performance obligation level (i.e., an entity would not separately recognize an asset or liability for each performance obligation within a contract but would aggregate them into a single contract asset or liability).</td>
</tr>
<tr>
<td>How should an entity determine the presentation of two or more contracts that have been required to be combined under the standards? [31 October 2014]</td>
<td>TRG members agreed that the contract asset or liability would be combined (i.e., presented net) for different contracts with the same customer (or a related party of the customer) if an entity is otherwise required to combine those contracts under the standards. However, TRG members acknowledged that this analysis may be operationally difficult for some entities because their systems will generally capture data at the performance obligation level to comply with the recognition and measurement aspects of the standards.</td>
</tr>
</tbody>
</table>
When should an entity offset contract assets and liabilities against other balance sheet items (e.g., accounts receivable)? [31 October 2014]

TRG members agreed that because the standards do not provide offsetting guidance, entities will need to look to guidance outside the revenue standards to determine whether offsetting is appropriate.

### Contributions

Today, not-for-profit entities that report under US GAAP follow ASC 958-605, Not-for-Profit Entities – Revenue Recognition, to account for contributions (i.e., unconditional promises of cash or other assets in voluntary nonreciprocal transfers). Contributions are not explicitly excluded from the scope of the FASB’s new standard. However, ASC 958-605 will not be wholly superseded by ASC 606.

### Questions raised

| Are contributions in the scope of the FASB’s new revenue standard? (This topic is not applicable for IFRS preparers.) [30 March 2015] | TRG members meeting in Norwalk, Conn., agreed that contributions are not within the scope of ASC 606 because they are nonreciprocal transfers. That is, contributions are generally not given in exchange for goods or services that are an output of the entity’s ordinary activities. TRG members meeting in London did not discuss this issue. |

### Islamic financing transactions

Islamic financial institutions (IFI) enter into Sharia-compliant instruments and transactions that do not result in IFIs earning interest on loans. Instead, these transactions involve purchases and sales of real assets (e.g., vehicles) on which an IFI can earn a premium to compensate it for deferred payment terms. Typically, an IFI makes a cash purchase of an asset, takes legal possession even if only for a short time and immediately sells it on deferred terms. The financial instruments created by these transactions are within the scope of the financial instruments guidance.

### Questions raised

| Before applying the financial instruments guidance, are deferred-payment transactions that are part of Sharia-compliant instruments and transactions within the scope of the revenue standards? [26 January 2015] | TRG members meeting in London agreed that Sharia-compliant instruments and transactions may be outside the scope of the revenue standards. However, the analysis would depend on the facts and circumstances and may require significant judgment because contracts often differ within and between jurisdictions. TRG members meeting in Norwalk did not discuss this issue. |

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1. Accounting Standards Update 2014-09, Revenue from Contracts with Customers (largely codified in ASC 606/IFRS 15 Revenue from Contracts with Customers).
2. Due to technological difficulties during the 30 March 2015 TRG meeting, TRG members attending the meeting in Norwalk, Conn., held a separate discussion from those attending the meeting in London.
3. For IFRS preparers, the standard uses the term “highly probable,” which is intended to have the same meaning as probable under US GAAP.
4. ASC 340-40, Other Assets and Deferred Costs – Contracts with Customers.