

# OUTSIDE AUDITOR COMMUNICATIONS WITH THE AUDIT COMMITTEE

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## I. INTRODUCTION

This paper is part of a series of papers that cover essential public and private company audit committee functions and responsibilities in a quick-read summary format. This paper covers the minimum communications that the outside auditor is required to have with the audit committee. These are also communications that should help the audit committee to perform its diligence and oversight functions. Audit committees are regulated or impacted by numerous statutes, cases, rules, regulations and pronouncements. While some audit committee responsibilities are mandatory, other committee functions and responsibilities are discretionary depending on the circumstances. Although an increasing number of the functions and responsibilities are specified by statute, rule or regulation, an audit committee's standard of care remains significantly dependent on due diligence and prudent judgment. Additional materials can be found at <http://davidtate.us>.

Contact me if you are looking for a speaker on these or other audit committee topics, or if you are looking for help with audit committee activities including help with an audit committee evaluation process.

The materials in this paper do not provide legal, accounting or other professional advice. These materials are not a solicitation for work. The materials do not apply to any particular person, entity, event, transaction or situation. These materials are only a summary. It should be clear that if you have questions or issues about a particular specific situation, you need to seek your own legal, accounting or other professional assistance, and you absolutely should not rely on the summary materials in this paper. The materials in this paper are update and changed periodically, and cannot be relied upon for that additional reason.

## II. OUTSIDE AUDITOR COMMUNICATIONS WITH THE AUDIT COMMITTEE

Various auditing pronouncements require the outside auditor to make certain inquiries of management, and of the audit committee members during the performance of a review or audit. Similarly, various accounting pronouncements also require the outside auditor to communicate specific information to management, and to the audit committee.

### A. Statements on Auditing Standards

Auditor's Communication with Those Charged with Governance. Statement on Auditing Standards (SAS) 114 requires the outside auditor to determine that certain matters relating to the audit of the

financial statements are communicated to those charged with governance, which at least includes the audit committee, and may include the board of directors.

Pursuant to SAS 114, the auditor should have access to the audit committee, the chair and other members of the audit committee should meet with the auditor periodically, and the audit committee should meet with the auditor without management present at least annually.

The auditor must at least communicate regarding the auditor's responsibilities under generally accepted auditing standards; the planned scope, performance and timing of the audit (including matters relating to internal controls); the extent that the auditor may use work of internal audit or outside accountants; and significant findings from the audit including but not limited to possible fraud, possible illegal acts, and material deficiencies or errors.

Other matters that the auditor may consider discussing with the audit committee include the committee members' views about the company's governance; objectives and strategies relating to risks that may result in material misstatement; internal controls and the committee's oversight of internal controls; the possibility of fraud; communications with regulators; the committee's actions in response to previous communications with the auditor; the committee's actions in response to developments in financial reporting, laws, accounting standards, and corporate governance practices; and other matters that the audit committee members believe are relevant to the audit of the financial statements.

Pursuant to SAS 114, the auditor should also communicate significant findings from the audit, such as significant difficulties, qualitative aspects of the accounting practices, uncorrected misstatements, disagreements with management, material corrected misstatements, and other significant issues that come to the auditor's attention.

Statement on Auditing Standards 114 specifically states that the auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. Inadequate two-way communications may indicate an unsatisfactory control environment, which may influence the auditor's assessment of the risks of material misstatement, or the auditor's ability to perform that audit.

Illegal Acts by Clients. The outside auditor should assure himself or herself that the audit committee, or others with equivalent authority and responsibility, is adequately informed about illegal acts that come to the auditor's attention. See Statement on Auditing Standards 54.

Additionally, §10A(a)-(f) of the Securities Exchange Act requires that the audit must include procedures designed to detect illegal acts; procedures designed to identify related party transactions; and an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern.

Consideration of Fraud in a Financial Statement. Statement on Auditing Standards 99 requires that the outside auditor ask management about knowledge or allegations of any fraud or suspected fraud affecting the company; management's understanding about the risks of fraud; programs and controls established to mitigate specific identified fraud risks, or that prevent, deter, and detect fraud; how management communicates to employees its views on business practices and ethics; and whether

management has reported to the audit committee on how the company's internal control serves to prevent, deter, or detect material misstatements due to fraud.

The auditor also should inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the company. The auditor also should obtain an understanding of how the audit committee exercises oversight of the company's assessment of the risks of fraud and the programs and controls the company has established to mitigate those risks.

Interim Financial Information. In a review engagement, such as with respect to quarterly financial information, the outside auditor performs certain required procedures, which may cause the auditor to become aware of significant information regarding the financial statements. If the outside auditor does become aware of certain information during the course of a review engagement, Statement on Auditing Standards 100 requires the outside auditor to communicate that information to management and the audit committee as appropriate.

Additionally, when conducting a review of interim financial information, the auditor should determine whether any of the matters described in SAS 114 have been identified. If any such matters have been identified, the auditor should communicate them to the audit committee or be satisfied that those matters have been communicated to the audit committee by management.

Understanding the Entity and its Environment. Statement on Auditing Standards 109 requires that the outside auditor obtain an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements (whether due to error or fraud), and to design the nature, timing and extent of audit procedures. The provisions of SAS 109 apply for all audits, and are not limited to an evaluation of internal control under Sarbanes-Oxley §404.

Statement on Auditing Standards 109 describes "internal control" as a process—effected by those charged with governance, management, and other personnel—that is designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control consists of five interrelated components: control environment, risk assessment, information and communication, control activities, and monitoring.

The "control environment" sets the tone of the organization, and influences the control consciousness of its people. SAS 109. The primary responsibility for the prevention and detection of fraud and error rests with those charged with governance and the management of the entity. In evaluating the company's control environment, the outside auditor is required to consider the entity's processes relating to communication and enforcement of integrity and ethical values; commitment to competence; participation of those charged with governance; management's philosophy and operating style; organizational structure; assignment of authority and responsibility; and human resource policies and practices.

With respect to evaluating the participation of those charged with governance, SAS 109 specifically identifies the following criteria: (1) independence from management, (2) the experience and stature of those charged with governance, (3) the extent of their involvement in and scrutiny of activities, (4) the

information that those charged with governance are provided, (5) the degree to which difficult questions are raised and pursued with management, (6) the ability of those charged with governance to evaluate the actions of management, (7) interaction with internal and outside auditors, (8) communications between management and those charged with governance, and (9) the ability of those charged with governance to understand the company's business transactions and evaluate whether financial statements are presented fairly in conformity with generally accepted accounting principles.

The outside auditor is required to evaluate whether a deficiency in internal control is significant enough to require communication of the deficiency to the audit committee, pursuant to SAS 112. Additionally, SAS 109 states that a significant internal control deficiency, or a lack of appropriate corrective response by management to a material deficiency, may raise doubt about the integrity of management, and whether it is possible to audit the financial statements.

Communicating Internal Control Related Matters Identified in an Audit. Statement on Auditing Standards 112 applies for all audits, and its application is not limited to an evaluation of internal control under Sarbanes-Oxley §404.

Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the company's financial reporting and internal control by those charged with governance;
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the company's internal control, even if management subsequently corrects the misstatement;
- An ineffective internal audit function or risk assessment function for a company for which those functions are important to the monitoring or risk assessment component of internal control;
- For complex entities in highly regulated industries, an ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting;
- Identification of fraud of any magnitude on the part of senior management;
- Failure by management or those charged with governance to assess the effect of a significant deficiency, and either correct it or conclude that it will not be corrected; and
- An ineffective control environment.

Significant control deficiencies or material weaknesses in control identified during the audit must be

communicated in writing to management and to the audit committee (and perhaps the board), including significant deficiencies and material weaknesses that were communicated in the previous audits, and that have not yet been remedied. The auditor's responsibility to communicate significant deficiencies and material weaknesses exists even if there has been a decision by management or those charged with governance to accept that degree of risk.

A significant deficiency is a control deficiency or combination of control deficiencies that adversely affects the company's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

A material weakness is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, individually or when aggregated with other misstatements, would clearly be qualitatively and quantitatively immaterial to the financial statements.

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, provides for three degrees of likelihood: probable, which means that the future event or events are likely to occur; reasonably possible, which means that the chance of the future event or events occurring is more than remote but less than likely; and remote, which means that the chance of the future event or events occurring is slight.

#### B. The Public Company Accounting Oversight Board, Auditing Standard No. 5

In 2007 the Public Company Accounting Oversight Board ("PCAOB") adopted Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, to replace Auditing Standard No. 2. Auditing Standard No. 5 applies to an audit of internal control, such as one performed under Sarbanes-Oxley §404, but does not otherwise apply generally with respect to an audit of the financial statements where internal controls are evaluated for the purpose of planning the audit, materiality and testing, but not for the purpose of issuing a specific opinion about the effectiveness of the internal controls.

Auditing Standard No. 5 states that the auditor should use a top-down approach to the audit of internal control over financial reporting, beginning at the financial statement level and company-level controls. Company-level controls include:

- Controls related to the control environment;
- Controls over management overrides;
- The company's risk assessment process;
- Centralized processing and controls;

- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment program;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

It is beyond the scope of these materials to discuss Auditing Standard No. 5 in detail. The Standard is discussed in other materials written by the author.

### C. Outside Auditor Independence

Independence Standards Board Standard No. 1 (which has been superseded, see below discussion) required that any auditor intending to be considered an independent accountant for purpose of the Securities Acts shall at least annually disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence; confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Securities Acts; and discuss the auditor's independence with the audit committee. Standard No. 1 has been superseded, but it is discussed in these materials because it is still referenced in various statutes, rules and regulations.

Public Company Accounting Oversight Board Rule (PCAOB) Rule 3526, Communication with Audit Committees Concerning Independence, replaced Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees. Rule 3526 provides that an outside auditor must:

- (a) Prior to accepting an initial engagement pursuant to the standards of the PCAOB (1) describe, in writing, to the audit committee of the issuer, all relationships between the outside auditor or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence; (2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the outside auditor, should it be appointed the issuer's auditor; and (3) document the substance of its discussion with the audit committee of the issuer.
- (b) At least annually with respect to each of its issuer audit clients (1) describe, in writing, to the audit committee of the issuer, all relationships between the outside auditor or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence; (2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the outside auditor; (3) affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the outside auditor is independent in compliance with Rule 3520; and (4) document the substance of its discussion

with the audit committee of the issuer.

Public Company Accounting Oversight Board Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting, states that in connection with seeking audit committee pre-approval to perform for an audit client non-audit service related to internal control over financial reporting, the outside auditor shall:

- Describe, in writing, to the audit committee of the issuer the scope of the service;
- Discuss with the audit committee the potential effects of the service on the independence of the firm; and
- Document the substance of its discussion with the audit committee of the issuer.

The note to Rule 3525 further states that an auditor is not independent if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

Public Company Accounting Oversight Board Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles, states that an outside auditor is not independent if the outside audit firm, or any affiliate of the firm, during the audit and professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless:

- (a) The person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;
- (b) The person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited (1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or (2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or
- (c) The person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are (1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and (2) completed on or before 180 days after the hiring or promotion event.

The note to Rule 3523 states that in an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of

tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

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