

CLIENT UPDATE

PCAOB TEES UP QUESTIONS FOR AUDIT COMMITTEES TO ASK AUDITORS ABOUT AUDIT INSPECTIONS

NEW YORK

Matthew E. Kaplan
mekaplan@debevoise.com

Peter J. Loughran
pjloughran@debevoise.com

Alan H. Paley
ahpaley@debevoise.com

Paul M. Rodel
pmrodel@debevoise.com

Steven J. Slutzky
sjslutzky@debevoise.com

Under the Exchange Act, the audit committee of a listed company or a company otherwise required to file SEC reports is directly responsible for oversight of the company's auditor. To facilitate this oversight role, the Public Company Accounting Oversight Board ("PCAOB") published, on August 1, 2012, a release proposing four questions about PCAOB inspections that audit committees of SEC registrants may want to ask their audit firms - including advice for audit committees about audit firm responses that should be viewed with skepticism.

According to the PCAOB, while some audit committees report that their audit firms provide helpful information about PCAOB inspections, other audit committees have told the PCAOB that "their auditors decline to discuss their PCAOB inspection results with them or downplay the results of any adverse findings that may be included in the report." The August 1st release attempts to assist audit committees in obtaining information about the results of a PCAOB inspection of the company's audit, as well as inspection results generally.

Under the Sarbanes-Oxley Act, the PCAOB is mandated to assess the degree of compliance with specified laws, rules and professional standards by each registered public accounting firm - whether located in the U.S. or elsewhere - that provides audit reports for SEC registrants. While the Sarbanes-Oxley Act requires that the PCAOB make a portion of its inspection reports publicly available, the PCAOB is not permitted to disclose discussions of an audit firm's quality control issues or criticisms of, and potential defects in, the firm's quality control systems if such criticisms and defects are addressed to the PCAOB's satisfaction within 12 months of the date of the inspection report. The contents of the confidential portions of an inspection report are, nonetheless, potentially of great interest to an audit committee. According to the August 1st release: "It is not unusual for an inspection report, particularly a report on one of the large, annually inspected firms, to include nonpublic criticisms of several aspects of a firm's quality control...."

The four questions and related PCAOB summary guidance are included as the last page of this update. We expect that the answers to these questions will be of interest not only to audit committees but to capital markets participants generally, including in connection with securities offering due diligence.

The full text of the August 1st release is available on the PCAOB web site at: http://pcaobus.org/News/Releases/Pages/08012012_InspectionProcess.aspx. Public portions of PCAOB inspection reports for individual audit firms are available on the PCAOB web site at: <http://pcaobus.org/Inspections/Pages/default.aspx>.

* * *

Please do not hesitate to call us with any questions on the August 1st release or audit committee questions generally.

August 13, 2012

APPENDIX: POSSIBLE QUESTIONS AUDIT COMMITTEES MAY WISH TO ASK THEIR AUDIT FIRMS ABOUT PCAOB INSPECTIONS

- **Was the company's audit selected for PCAOB inspection?** Committees may want real time updates about whether their audit has been selected, what is being looked at, and any deficiencies identified by the PCAOB in the audit. The release provides additional information about specific areas for possible further inquiry in this regard.
- **Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit?** Committees may wish to understand whether similar deficiencies exist in the company's audit and, if so, what has been done in response.
- **What were the audit firm's responses to the PCAOB findings?** Committees may want to understand whether the audit firm agreed with the PCAOB's findings and, if not, why not. If the firm agreed, what did the firm do in response? The PCAOB is aware of certain audit firm responses that should be viewed with skepticism, such as:
 - *"It was just a documentation problem."* The PCAOB bases deficiency findings on an absence of available evidence in the audit files or elsewhere to support that adequate work was done to support an audit opinion, not just a failure to document work that was in fact done. Audit firms are provided an opportunity to describe the details of work that was done but not documented.
 - *"There was a difference in professional judgment."* The PCAOB bases deficiency findings only on failures to obtain sufficient audit evidence, not on disagreements when reasonable judgments appear to have been made about such matters.
 - *"The firm has addressed the criticisms in accordance with PCAOB standards."* Professional standards require that when a required auditing procedure was omitted, certain remedial steps must be taken. Ask whether the firm performed more work in response to the finding or in subsequent audits, or whether the firm concluded that no additional steps were required – in other words, that the firm disagrees with PCAOB inspection conclusions.
- **What topics are included in Part II findings?** Firms may be reluctant to share the details of Part II findings in an inspection report for a number of reasons, but even in that case, audit committees may want to ask for certain generic information about the findings such as:
 - what changes the firm is making to address any quality control deficiencies;

- what is the progress of the quality control remediation process, including a discussion of any submissions the audit firm made to the PCAOB as part of that process;
- the inspected years about which the PCAOB has made a final determination about the firm's remediation efforts and the nature of that determination; and
- whether the PCAOB has provided initial indications that the audit firm may not have sufficiently remediated any items.