Emerging Issues that may affect audits, auditors, or the PCAOB

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The views expressed by each of the presenters are their own personal views and do not reflect those of the PCAOB, members of the Board, or the PCAOB staff.

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Emerging Issues

1. New Accounting Standards
    - New Revenue Recognition Standard and Pace of Accounting Change
2. Profession
    - Audit Firm of the Future
    - Attractiveness of the Profession / Talent
3. Economic and Political Developments
4. Standard Setting
    - The Auditor’s Role in Relation to Information Outside the Financial Statements
    - Auditor’s Consideration of Noncompliance with Laws and Regulations

New Revenue Recognition Standard and Pace of Accounting Change

New Revenue Recognition Standard

- **Background / Issue:**
  - Many public companies will be adopting the new revenue standard on January 1, 2018, and auditors will be required to perform a review of the first quarter interim financial statements
  - Changes to issuers' internal controls over financial reporting (ICFR) will be required that will create new/additional risks that auditors need to identify and assess
  - Evaluating the application of ASC 606 will require the exercise of significant judgment and require the reconsideration of risks (e.g. incentives, opportunities, motivations, etc.)
  - Various interpretations of the new standard may evolve
  - Auditors will be discussing the adoption with audit committees
  - An audit firm's system of quality control will need to enable teams to audit the new revenue standard (e.g. training, coaching, consultations, etc.)

New Revenue Recognition Standard and Pace of Accounting Change

New Revenue Recognition Standard

- **Potential Implications / Discussion Points:**
  - What is the current state of readiness for the adoption of the standard among issuers? Among auditors?
  - Is the state of readiness in the U.S. similar to Europe and elsewhere around the world?
  - Which aspects of the standard are proving to be the most challenging or complex to apply?
  - How will unresolved financial reporting issues (e.g., questions from industry) be addressed by auditors to assess issuers' application of the standard and what are the implications to audits?
  - How are audit firms enabling audit teams to identify risks and design/execute an effective audit strategy?
  - How will audit firms address the potential for different outcomes based on similar fact patterns?
  - What evidence will auditors require to test the selected transition approach and ongoing reporting?
  - What is the appropriate degree of audit committee and auditor engagement on the issuer's implementation, including the quality of its financial reporting?
  - What action(s) should the PCAOB be taking to help provide for an effective and successful transition to this new standard?

New Revenue Recognition Standard and Pace of Accounting Change

Pace of Accounting Change

- **Background / Issue:**
  - Significant transition efforts are underway for new accounting standards related to revenue recognition (2018), leases (2019), credit losses (2020), as well as a number of others. The FASB also has a number of other standards under development.
  - These new standards will likely drive significant changes in issuers' ICFR, impacting auditors' risk assessments
  - Auditors' systems of quality control will need to enable teams to audit the new standards
- **Potential Implications / Discussion Points:**
  - How are issuers and audit firms addressing the pace of accounting change?
  - What will need to be understood relating to the transition process and identification of risks? For example:
    - Consideration of risks associated with (1) the determination of the accounting policies, (2) controls over the determination of transition adjustments and (3) changes in ICFR to support accounting post-transition
    - Consideration of any new incentives or opportunities that are created as part of the transition process, and companies' plans to address them
    - Understanding of effect new accounting will have on evaluation of company performance by stakeholders
  - What is the appropriate degree of audit committee and auditor engagement?
  - How will audit firms train its professionals on new standards and enable them to perform their risk assessments and execute procedures?
  - What action(s) should the PCAOB take to help provide for an effective and successful transition to the new standards?

Audit Firm of the Future

- **Background / Issue:**
  - Consulting and advisory services continue to grow and outpace audit-related revenue.
  - Investors increasingly rely on data not subject to audit (e.g., KPIs, non-GAAP financial and operating metrics, and sustainability reporting).
  - Technology
    - Rapidly changing technology is disrupting business on a massive scale: big data, cloud computing, virtual supply chains, artificial intelligence, existential dependence on connectivity.
    - New technology is being introduced every day that impacts how audits can be performed. Audit firms and preparers are making significant investments in technology, specifically regarding the use of data. These investments have the potential to enhance quality, provide additional insights and enhance the experience of staff.

Audit Firm of the Future

- **Potential Implications / Discussion Points:**
  - Growth in Consulting / Advisory services
    - What are the implications of the rise in consulting / advisory services (that typically exceed audit related revenue), including any independence issues?
    - Are audit client issuers less forthcoming when the auditor's advisory partners work for competitors?
    - Can the audit practice maintain its centrality in the overall firm?
    - Does providing these services require better talent, which in turn, would provide a higher quality audit?
  - Attestation / Assurance products of the future
    - How can auditors increase the relevance of audits in a world where investors increasingly rely on non-financial information (e.g. non-GAAP financial metrics, non-GAAP operating metrics, sustainability info)?
    - Should audit firms support the creation of more non-FASB standard metrics and assure against them?
  - Audit of the future
    - Is the standard model of adding more tests by adding time/people still efficient and sustainable?
    - How does big data / artificial intelligence get leveraged?
    - How does technology (e.g. remote inventory count; augmented reality, RPA; drone technology, etc.) get leveraged?
    - Do audits evolve to permanent, evergreen auditing with real-time assurance?
    - Can audit firms differentiate and compete based on audit quality?

Attractiveness of the Profession / Talent

- **Background / Issue:**

  - The potential changes in the audit environment, such as changes in the use of data analytics and technology, offshoring, and proliferation of non-GAAP measures, may create challenges for recruiting and retaining top talent. The recruitment and retention of quality individuals is key to improving audit quality.

  - Today's graduates are different than previous generations and understanding their skills and demands are important in developing a sustainable workforce. Additionally, consulting and advisory services may be more attractive to today's top graduates.

  - Turnover at the firms among experienced auditors (including early partner retirements) appears to be increasing.

Attractiveness of the Profession / Talent

- **Potential Implications / Discussion Points:**
  - How should the capabilities needed by auditors change to meet expectations of their roles and responsibilities in the future? For example, data analytical skills to interpret big data, business acumen skills to assist in the assurance of more “forward looking” information or non-GAAP measures, and forensic skills?
  - Will the impact of mandatory audit firm rotation in Europe cause increased marketing and relationship building skills to be developed? If yes, are their independence implications for SEC registrants based outside the US?
  - Do auditors have the requisite experience to appropriately understand their client’s industries?
  - Is there enough innovation in the audit process itself for today’s graduates who may seek more intellectually stimulating work earlier in their careers than previous generations of graduates?
  - Does the profession do enough to make today’s graduates understand the social utility of the audit?
  - How are college curriculums updated to keep pace with the numerous changes in the profession?
  - Will the cost associated with attracting talent and developing these skills cause more disparity between big and small audit firms?
  - Can the audit practices of larger firms compete for talent with consulting and advisory services practices?
  - Is the work environment at audit firms too intense for younger people?
  - Is there a higher attrition rate amongst experienced auditors, and if so, why?
  - Why are audit partners retiring earlier? Is it related to the intense scrutiny, increased pressure with continual change, or the expectation that auditors should be at forefront in the fight against fraud and corruption? What can be done?

Economic and Political Developments

There are economic and political developments that could have a significant impact on financial reporting and audits, such as

- Regulation and Legal
  - Tariffs
  - Trade control
  - Antitrust
  - Data protection
  - Environmental

- Tax reform
  - Jobs and economic growth
  - Global competition
  - Dividend policy
  - Debt and equity financing
  - Foreign source earnings

- Currency and Monetary Policy
  - Inflation
  - Interest rates
  - Capital availability

- Geopolitical Risk
  - State collapse or crisis
  - Failure of national government
  - UK's exit from EU

- Immigration
  - Economic impact of changes in immigration policies
  - Workforce availability

- Black swans
  - Consumer confidence (meltdown)
  - Trade wars (impact on imports and exports)
  - Military intervention (realignment of Federal budget priorities)
  - Capital formation (interest rates, tax reform, uncertainty)
  - Worker productivity (positive impact from AI, robotics, education and training)

Economic and Political Developments

Potential Implications / Discussion Points:

- What are the most significant economic and political developments that affect financial reporting and audit risk? What are the potential implications?

- How could future cash flows and resulting audit risk be impacted by economic and political developments, such as, valuation of goodwill or other long-lived assets, going concern, deferred tax assets, collectability of loans/receivables, and disclosures?

Other issues:

- Could pressure on management lead to aggressive accounting? How should auditors adjust their risk assessments?

- Will there be stresses on internal controls over financial reporting that impact an auditor's reliance on a company's system of internal controls?

- Could there be an increase in significant unusual transactions that deserve special attention, especially those presenting difficult issues of form versus substance? Audit considerations?

- What specialized knowledge would need to be added to audit teams?

The Auditor's Role in Relation to Information Outside the Financial Statements

- **Background / Issue:**
  - At the November 2015 SAG meeting, the auditor's role in relation to non-GAAP measures was identified as an emerging issue.
  - At the May 2016 SAG meeting, the SAG held a discussion on company performance measures, including non-GAAP measures, and the role of auditors:
    - The staff briefing paper noted that the auditor is required to read and consider information outside the financial statements (in an annual or quarterly report) for material inconsistency with information in the financial statements, but the auditor does not have a responsibility to perform specific procedures related to corporate earnings releases, investor presentations, or other communications where non-GAAP measures may appear.
    - Some SAG members noted that reporting, use of, and reliance on non-GAAP measures have increased and questioned whether the auditor's responsibilities should change.
  - In December 2016, the PCAOB added a related, but broader, research project to its Research Agenda to explore the auditor's role in relation to information outside the financial statements.

The Auditor's Role in Relation to Information Outside the Financial Statements

- **Potential Implications / Discussion Points:**
  - Should the auditor’s role and responsibilities change in relation to information outside the financial statements?
    - Depending on the <u>type of information</u>?
      - Non-GAAP measures (e.g., EBITDA)
      - KPIs (e.g., unit sales or number of subscribers)
      - MD&A (or portions of MD&A, like critical accounting policies and estimates)
      - Environmental, Social, and Governance (ESG) reporting
    - Depending on the <u>document in which the information appears</u>?
      - Annual report/quarterly report
      - Earnings release
      - Any other relevant communications
  - If so, what should the auditor be doing?
  - Are auditors currently performing procedures in these areas? If so:
    - Is it happening because the auditor thinks it is necessary?
    - Is it happening at management’s or the audit committee’s request?
    - In which areas (described above or others) is the auditor performing procedures?

Auditor's Consideration of Noncompliance with Laws and Regulations (“NOCLAR”)

- **Background / Issue:**
  - Regulatory and investor attention to company violations of laws and regulations has been on the rise over the past few years.
    - From 2009 through 2015, companies were assessed about $12 billion in fines, penalties, and forfeitures for violations of laws and regulations. (GAO, Mar. 2016)
  - SAG members discussed whistleblower activity as an emerging issue at November 2015 and May 2016 SAG meetings. Among the observations were that:
    - Companies’ whistleblower activity has resulted in investigations and attention on auditors’ consideration of those investigations.
    - A larger project could more broadly address the auditor's consideration of a company's noncompliance with laws and regulations.
  - In December 2016, the PCAOB added NOCLAR to its research agenda. The staff is exploring whether there is a need for improvements to AS 2405, *Illegal Acts by Clients*, to provide better direction to auditors regarding their responsibilities with respect to illegal acts.

Auditor's Consideration of Noncompliance with Laws and Regulations (“NOCLAR”)

- **Auditor’s Current Responsibilities:**
  - *Detection*. Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud. This includes misstatements resulting from illegal acts that have a **direct and material effect** on the financial statements, such as a violation of a tax law that affects accruals and the amount recognized as expense (Section 10A of the Exchange Act, PCAOB standards).
    - For all other illegal acts, specific audit procedures designed to detect such illegal acts are not required. This includes illegal acts with a **material but indirect effect** on the financial statements, such as a violation of a safety or other operating regulation that gives rise to a material penalty. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention.
  - *Investigation*. When an auditor becomes aware of information concerning a possible illegal act, the auditor is required to obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect of the act on the financial statements.
  - *Reporting*. As soon as practicable, the auditor must inform company management of the illegal act (whether or not material to the financial statements) and assure that the audit committee is adequately informed of the act, unless the illegal act is clearly inconsequential. [In some circumstances, reporting to the SEC may also be required.]
- **Potential Implications / Discussion Points:**
  - Should auditors’ responsibilities in relation to illegal acts be changed? If so, how? What are the pros and cons?
  - Potential considerations for discussion:
    - Investor harm/market reaction; types of illegal acts; qualitative and quantitative materiality; adequacy of disclosures.