



# The New PCAOB Board Signals Positive Change for the Future

by

Bob Conway

*CNM Senior Professional Practice Director*

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We are finally starting to see some clarity as to what can be expected from the all new five-member PCAOB Board. This clarity has come through recent speeches from PCAOB board members, including the remarks of Board Member Duane DesParte at the UC Irvine Audit Committee Summit.

## Reporting the Nature and Severity of Inspection Findings

Perhaps the most positive news comes from proposed changes to the manner in which the PCAOB reports inspection findings – reporting both the nature and severity of the identified findings. In the past, audit deficiencies were reported without meaningful differentiation as to severity. This resulted in the reporting of deficiency rates by the financial press for each audit firm (based on the number of audits with at least one deficiency as a percentage of the total number of audits inspected). The significant flaw in this approach has been that all deficiencies were treated equally, when in fact, some deficiencies are considerably more severe than others (particularly those that may have resulted in restatements of the financial statement audit opinion or the auditors' report on internal controls).

PCAOB Chairman Dunhke stated, "We hope that our modified approach to inspections reporting will begin to shift the public dialogue away from a mere quantification of audit deficiencies to a more balanced and meaningful assessment of audit quality."

I have suggested to the new PCAOB board that what investors really want to know is: 1) the number of restatements of financial statements or internal control reports resulting from its inspections and 2) deficiencies in auditing that could have resulted in the failure to detect a material misstatement in the financial statements.

How this will all play out remains to be seen. The exact timing and application of these proposed changes has yet to be determined but I would expect that they will be implemented starting with

the 2019 inspection season.

## The Prospect of Interpretive Guidance from the PCAOB

Going forward, the PCAOB may be providing more guidance on how to comply with its standards. Board Member James Kaiser (a retired senior partner from PwC), explained that the PCAOB was looking to provide guidance on how to comply with the PCAOB's standards. "This could include more frequently published guidance, staff reports, and practice alerts ... and a more formal consultation process."

This is a positive step in the right direction. To date, preparers and auditors alike have felt like the PCAOB's expectations for its principles based standard on ICFR have been a moving target, with expectations increasing with each passing inspection season. Clarity as to what is required is essential to all stakeholders.

Other standard setters such as the FASB provide considerable guidance when new standards are rolled out. Just look at the FASB/IASB Joint Transition Resource Group on the new revenue recognition standards (with over 50 consultation topics), as well as the new lease and CECL standards, and the ongoing work of the Emerging Issues Task Force.

## A First at the PCAOB -- A Board Member with Significant Preparer Experience!

For the first time in its 15-year history, an individual joins the PCAOB board with significant experience as a financial statement preparer. Board Member Duane DesParte, a CPA, was the corporate controller of a Fortune 100 company for 10 years before becoming a PCAOB board member. We believe that public registrants hope and expect that Board Member DesParte will be mindful of the challenges and frustrations that many public companies have experienced building out their SOX compliance programs to satisfy auditor and regulator expectations.

Rounding out the new PCAOB board are a legislative and operational expert (the PCAOB Chairman William Dunhke III was formerly a Senate Banking Committee staffer), a retired Big Four partner (James Kaiser), a professor who specializes in corporate governance (J. Robert Brown), and a securities attorney with a unique focus on risk management, Fintech, and cybersecurity (Kathleen Hamm).

## **An Update on 2018 PCAOB Findings – Very Consistent with the Past**

Chairman Dunhke provided an update on the preliminary results of the 2018 inspections, noting the following:

“The most frequent audit deficiencies identified continue to be in the same three key areas we have discussed over the past few years:

- > Auditing internal control over financial reporting (ICFR)
- > Assessing and responding to risks of material misstatement, and
- > Auditing accounting estimates, including fair value measurements.

Audit deficiencies have been most frequently observed in auditing of the following financial reporting areas:

- > Revenue
- > Impairment of long-lived assets
- > Inventory
- > Financial instruments
- > Allowance for loan loss;
- > Business combinations
- > Debt and equity instruments”

## **Guidance on Critical Audit Matters (CAMs)**

Chairman Dunhke also reported, “Beginning in the second half of next year, audit reports for Large Accelerated Filer will include Critical Audit Matters

or CAMs. For others, CAMs will be effective in 2020. CAMS are meant to make the auditor’s report more useful by providing additional and important information to the users of the financials. They will inform users of high risk audit matters that the auditors had to deal with and how the auditors addressed those matters. CAM determination is principles-based. It begins with audit matters that were communicated or required to be communicated to the audit committee. CAMS must relate to a material account or disclosure in the financial statement. To be a CAM, the matter should be challenging, subjective, or involve complex auditor judgment.”

“Larger audit firms have conducted pilot programs on a few issuers and will soon complete more extensive dry-runs. ... [Public company] preparers and audit committees should ensure their companies participate in a dry-run with their auditors in the year before the adoption of the new standard.” It is reasonable to expect that CAMs will be a significant area of focus by the PCAOB in future inspections.

## **Upgrading the Quality Control Standards for Auditors**

Board Member Kaiser reported that, “We also have several items on the forward standard-setting agenda. ... The first is quality control. The current QC standards have been in place since the mid-90s” (before the turn-of-the-century failures of Enron, WorldCom, HealthSouth, Tyco, AIG, etc.). Yes, the existing QC standards are antiquated and long overdue for updating. The PCAOB expects that a good system of quality control within each audit firm should be able to monitor the progress of the audit and flag troubled audits while they are in process -- so that appropriate remediation can be completed prior to report issuance.”

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If you have any questions or would like further information, feel free to contact me at [RConway@CNMLLP.com](mailto:RConway@CNMLLP.com) or call me at (714) 392-2499.



**LOS ANGELES**

A | 21051 Warner Center Lane  
Suite 140  
Woodland Hills, CA 91367  
o | 818.999.9501

**ORANGE COUNTY**

A | 6 Venture  
Suite 365  
Irvine, CA 92618  
o | 949.299.5582



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