NASBA

National Association of State Boards of Accountancy

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July 29, 2016

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via e-mail: comments@pcaobus.org

Re: Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors; PCAOB Rulemaking Docket Matter No. 042

Dear Members of the Public Company Accounting Oversight Board:

We appreciate the opportunity to offer comments on the Proposed Amendments referred to above. The National Association of State Boards of Accountancy's (NASBA) mission is to enhance the effectiveness and advance the common interests of the Boards of Accountancy that regulate all certified public accountants and their firms in the United States and its territories. In furtherance of that objective, we offer the following comments on the Proposed Amendments.

We support the Board's project to improve and clarify the standards of the PCAOB that address audits involving the use of accounting firms and individual accountants that are not part of the accounting firm that issues the audit report. We also believe it is important to incorporate the PCAOB's risk based standards into the role of the lead auditor in their supervision over other auditors.

Definitions

Under the proposed amendments (Appendix A1.A4), the "lead auditor" is defined as:

> "a. The registered public accounting firm issuing the auditor's report on the company's financial statements and, if applicable, internal control over financial reporting; and
>
> b. The engagement partner and other engagement team members who: (1) are partners, principals, shareholders, or employees of the registered public accounting firm issuing the auditor's report and (2) assist the engagement partner in fulfilling his or her planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201.23."

Including individual team members in the definition of the "lead auditor" could create confusion and practical challenges. The PCAOB may want to consider further refinements in the definition.

Serving as the Lead Auditor in an Audit that Involves Other Auditors or Referred-to Auditors

Under the proposed amendments (Appendix A1.B2):

> "In an audit that involves other auditors or referred-to auditors, the engagement partner should determine whether the participation of his or her firm is sufficient for the firm to carry out the responsibilities of a lead auditor and to report as such on the company's financial statements. In making this determination, the engagement partner should take into account the risks of material misstatement associated with the portion of the company's financial statements for which the engagement partner's firm performs audit procedures (which includes considering the portion's materiality), in comparison with the portions for which the other auditors perform audit procedures or the portions audited by the referred-to auditors."

The Securities and Exchange Commission's Division of Corporate Finance's Financial Reporting Manual (4140 Principal Auditor) uses the term "principal auditor:"

> "Generally, the principal auditor is expected to have audited or assumed responsibility for reporting on at least 50% of the assets and revenues of the consolidated entity."

We recommend that the PCAOB and SEC use consistent criteria to determine the lead auditor's responsibility.

The change in the definition of the "lead auditor" under the proposed amendments could result in situations where the firm which currently acts as a lead auditor may no longer be determined to be the "lead auditor." This could inadvertently result in a new lead auditor that is prohibited from performing the work because they are unlicensed in the United States (or foreign jurisdiction) or fail to meet other local regulations. NASBA cautions that any final PCAOB requirements need to take into account the state accountancy regulations that use differing statutory language and interpretations to limit the signing of auditor reports to licensed individuals working in registered accounting firms, typically with licensure in the location of the client's home state.

Under the *6th Edition of the Uniform Accountancy Act* (released in 2011), only individuals who were licensed or had practice privileges in a state could sign or authorize signing an audit report for a client having its "home office" in that state, and only through an accounting firm registered in that state. The *7th Edition of the UAA* (released in 2014) removed the reference to "home state" and lifted the firm registration requirement under certain circumstances. Language from both versions of the UAA has been implemented in a number of states in the past five years. Both the 6th and 7th editions of the UAA require that anyone signing or authorizing a signature on a report must be licensed in at least one U.S. jurisdiction. UAA §7(c)(3) & (4) have been adopted nearly verbatim in many jurisdictions. However, several jurisdictions have retained explicit licensure requirements for any individual signing auditor reports in their jurisdictions. A few states also have in place additional competency requirements for individuals signing auditor reports.

Some state boards have previously raised concerns with the PCAOB regarding unregistered firms and/or unlicensed individuals (including foreign auditors not licensed in any U.S. jurisdictions) signing reports for clients located in their states. As a result, the PCAOB now includes language in its registration letters to all PCAOB registered firms reminding registrants about the role of state regulations.

In some audits, the engagement team may be organized in a multi-tiered structure. For example, another auditor might audit the financial information of a location or business unit that includes the financial information of a sub-location, or subunit, audited by a second or third other auditor. We believe that the lead auditor's responsibility for the supervision of other auditors should cover the first level of other auditors, with those auditors then being responsible for overseeing the work of those answering to them. This organizational structure is intended to avert significant delays and, at the same time, not dilute the lead auditor's responsibility for the entire audit, nor the responsibility of each of the tiered auditors.

Procedures to Be Performed by the Lead Auditor with Respect to the Supervision of the Other Auditors' Work

Currently proposed amendments do not distinguish between in-network and out-of-network other auditors. The *AICPA Professional Code of Conduct*, as referenced by most State Boards of Accountancy (§1.220.010.18), defines firms in a network. One characteristic in the determination of a network firm under the Code's interpretation is sharing common quality control policies and procedures that are monitored by the association. Given this commonly applied definition, there should be some distinction made between the levels of supervision of in-network vs out-of-network firms.

Under the proposed amendments to AS 1215 (Audit Documentation):

> "The office issuing the auditor's report must obtain, and review and retain, prior to the report release date, the following documentation related to the work performed by other offices of the firm and other auditors… i. All matters to be communicated to the audit committee."

Since the PCAOB has recently issued a proposed auditing standard on the *Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which includes a new requirement for the information to be reported in the audit report, we suggest that the information requirement from other auditors align with the information required to be ultimately reported in the audit report by the lead auditor (e.g. Critical Audit Matters).

Responsibilities of Other Auditors

Under the proposed amendments, the substantial responsibility for completing the audit lies with the lead auditor. There could be circumstances where other auditors will perform audits for their local clients at the same time and, thus, will have less time and accountability for the work performed for the lead auditor located in another firm/office. Absence of the explicit incentives/ requirements for other auditors in the proposed amendments could diminish the other auditor's accountability for the work the other auditor performs.

Other Auditors' Compliance with Independence and Ethics

Under the proposed amendments (Appendix A1.B4):

> "In an audit that involves other auditors, the lead auditor should determine each other auditor's compliance with the SEC and PCAOB independence and ethics requirements by:
>
> a. Gaining an understanding of each other auditor's knowledge of the SEC and PCAOB independence and ethics requirements and their experience in applying the requirements; and
>
> b. Obtaining a written representation from each other auditor that it is in compliance with SEC and PCAOB independence and ethics requirements."

Obtaining independence and ethics confirmations from each individual member of the other auditor's team could result in significant delays in completion of the audit and issuance of the audit report by the lead auditor. The same objective could be met by obtaining from the engagement partner of the other auditor a confirmation of the compliance with the independence and ethics of its engagement team.

The proposed amendments (Appendix A1.B4) state:

> "In an audit that involves other auditors, the lead auditor should determine each other auditor's compliance with the SEC and PCAOB independence and ethics requirements…"

To allow for such confirmation, we suggest the term "determine" be replaced with "obtain confirmation of"

Registration Status of Other Auditors

The proposed amendments (A1.B5) state:

> "In an audit that involves an other auditor that would play a substantial role in the preparation or furnishing of the lead auditor's report on the company's financial statements and, if applicable, internal control over financial reporting, the lead auditor may use an other auditor only if the other auditor is registered pursuant to the rules of the PCAOB."

We suggest adding the specification that the lead auditor may use an other auditor against whom there are currently no PCAOB sanctions and that is in compliance with applicable state laws and regulations, including state CPA licensure requirements.

Performing Procedures with Respect to the Audit of the Referred-To Auditor

Under the proposed amendments (Appendix 2.06.b):

> "The lead auditor may divide responsibility for the audit with another accounting firm only if: …
>
> b. The financial statements of the company's business unit audited by the referred-to auditor were prepared using the same financial reporting framework as the financial reporting framework used to prepare the company's financial statements."

There appears to be an inconsistency between this proposal and SEC practice as it requires the financial statements of the company's business unit audited by the referred-to auditor should be prepared using the same financial reporting framework. The SEC's *Financial Reporting Manual* (FRM) (6820.7) currently allows for financial statements of subsidiaries to be on a different basis of GAAP than the registrant as long as the audit report is clear as to which auditor is taking responsibility for the conversion of the GAAP of the subsidiary to the GAAP of the issuer.

Proposed Amendments to AS 2110 (Identifying and Assessing Risks of Material Misstatement)

Under the proposed amendments to AS 2110 (Appendix 3.11A):

> "If the auditor serves as a referred-to auditor in accordance with AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, as part of obtaining an understanding of the company, the referred-to auditor should consider making inquiries of the lead auditor as to matters that may be significant to the referred-to auditor's own audit…"

We believe that the phrase "should consider" should be strengthened to "should make inquiries."

Proposed Amendments to AS 2410 (Related Parties*)*

Under the proposed amendments to AS 2410 (Appendix A3.09):

> "…the lead auditor also should inquire of the other referred-to auditor regarding the other referred-to auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications."

We believe the sentence above should read

> "…the lead auditor also should inquire of the other referred-to auditor regarding the other referred-to auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the <u>lead</u> auditor's communications."

For consistency, we suggest that all requirements with the other referred-to auditor be included in or cross-referenced to AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm.*

Example of Reporting by the Lead Auditor Indicating the Division of Responsibility When Making Reference to the Audit and Report of the Referred-To Auditor

The proposed amendments (Appendix 2.B1) include an example of reporting by the lead auditor indicating the division of responsibility when making reference to the audit and report of the referred-to auditor. Since the PCAOB has recently issued a proposed auditing standard on the *Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion*, the proposed examples of audit reports in the current proposed amendments should be either included in, or cross-referenced to, the auditing standard on the *Auditor's Report on an Audit of Financial Statements*, once the proposed amendments are finalized.

Under the proposed amendment in AS 1206.08 (c):

> "The lead auditor's report should disclose the magnitude of the portion of the company's financial statements and, if applicable, internal control over financial reporting audited by the referred-to auditor."

In current practice, when there is more than one referred-to auditor, the auditor's report generally combines the disclosure about the magnitude for all referred-to auditors. It is not clear if the PCAOB's intention is to have this disclosure be made for each referred-to auditor. We recommend the PCAOB consider whether and how this may conflict with current practice. The PCAOB may want to include a report example when multiple referred-to auditors exist.

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Again, we appreciate the opportunity to comment on the Exposure Draft.

Very truly yours,

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NASBA Chair

Ken L. Bishop
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