ICAEW REPRESENTATION 115/16

PCAOB Release No. 2016-002, April 12, 2016

Rulemaking Docket No. 042

Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard - Dividing Responsibility for the Audit with Another Accounting Firm

ICAEW welcomes the opportunity to comment on the PCAOB's Release No. 2016-002, April 12, 2016, Rulemaking Docket No. 042 *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard - Dividing Responsibility for the Audit with Another Accounting Firm* published on 12 April 2016, a copy of which is available from this link.

This response of 29 July 2016 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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MAJOR POINTS

1. The PCAOB's inspection work highlights important issues with regard to the conduct of group audits. There are genuine difficulties for auditors associated with complex group structures, local licensing requirements, different auditing and reporting requirements, access restrictions and cultural and linguistic barriers. In particular, we appreciate the frustration experienced by lead auditors and regulators alike with structural and other limitations arising from these issues. We acknowledge that auditors sometimes fall short of the required standards in conducting group audits and that there is a real need for improvement. We therefore welcome this opportunity to respond to these proposals.

The role of standard-setting, and securities and audit regulators in improving group audits

2. Changing behaviour requires the co-operation of a number of stakeholders and a multi-faceted approach combining direction, guidance, incentives and sanctions. Above all, successfully changing behaviour requires a clear understanding of the sub-optimal status quo, the dynamics that perpetuate it, and the different courses of action available to deal with the problems. In other words, the proposals need to reflect and address root causes of the problems the PCAOB rightly identifies. The PCAOB also needs to consider how standard-setting fits in with the other courses of action needed to address them on a holistic basis.

3. On the face of it, the proposals are about 'tightening up', making sure that lead auditors are sufficiently involved in group audits, and that other auditors who are necessarily involved in group audits of any size, do what they are supposed to do. These are simple and worthy objectives and we welcome initiatives by standard-setters such as the PCAOB to break down established patterns of behaviour and to create new ways of thinking and working within and between audit firms to achieve these objectives.

4. Government, audit inspectorates and securities regulators, including the PCAOB and the SEC, have an important role to play in improving group audits. We urge them to continue their dialogue to overcome the long-term structural barriers to the improvement of lead and other auditor performance. It is asking too much to expect standard-setting alone to improve audit quality. The PCAOB in particular has a leading role to play in improving group audits in its capacity as an audit inspector and it is held in exceptionally high regard internationally. US audit inspectors are perceived as diligent. US regulatory excellence has taken a decade or more to build and its foundations are solid. Those foundations include a clear and detailed understanding of the dynamics of audit firms and audit practices and many non-US audit regulators have been modelled on the PCAOB with good reason. It is critical that the PCAOB retains this status internationally and that the strength and wisdom of the US approach are not undermined. To do this, it *must* ensure that what it is does actually addresses the underlying problems with performance in group audits, and that unintended consequences are avoided. The best way to achieve this is by properly understanding the real root causes of poor performance in group audits. That, in turn, involves understanding clearly how and why group audits are conducted in the way that they are.

Understanding the root causes of poor auditor performance is not easy, but it is the only way to improve it

5. Some of the root causes of poor auditor performance are not obvious, there are many of them, their specific effects are hard to isolate and not all of them can be remedied by auditors and the PCAOB. Poor quality staff and audit methodologies, insufficient resources generally and inadequate training in particular can all be addressed, as can structural disincentives within firms. But the complex regulatory, legal and commercial infrastructure is also an important contributory factor. If this is not acknowledged, change is likely to be of limited value. It is therefore particularly important to work *with* auditors on the logistics of group audits that reflect complex group structures.

6. The PCAOB's observations regarding the hazards involved in inadequate supervision of other auditors are real. Some of the proposed solutions, however, have an administrative feel to them and, despite assertions regarding the risk-based nature of the proposals, are highly prescriptive in a number of important respects. In short, some of the proposals seem primarily designed to improve ease of inspection, and we are concerned that they will have little substantive effect on the performance of group audits. In particular, we doubt that some of the additional documentation requirements and confirmation of compliance with current requirements (such as the adequacy of involvement) will, of themselves, improve the quality of procedures performed, whether by lead or other auditors.

Working constructively with other audit regulators, and with experienced and competent local auditors

7. We believe that the International Forum of Independent Audit Regulators (IFIAR) has the potential to play a vital role to play in co-ordinating the oversight of cross-border audits and that it is in a unique position to add value to group audits. We encourage the PCAOB to engage in a dialogue with IFIAR to develop its potential in this respect. In order for IFIAR to fulfil its role, it too needs to acknowledge that companies and their auditors now operate on a regional and business line basis. Questions regarding how lead auditors in the US deal with auditors from a particular jurisdiction no longer make sense in isolation – it is just as important to understand how non-US 'other' auditors manage and supervise second 'other' auditors in the regions for which they take responsibility in group audits. IFIAR is in a unique position to approach the review of group auditors in this manner.

8. Reports of audit regulators from around the world note situations in which instead of working constructively with experienced and competent other auditors, lead auditors send inexperienced staff into locations that they do not understand economically, culturally or linguistically, and instruct them to perform work appropriate in the lead auditors jurisdiction. As a result, not very surprisingly, they fail to perform a proper risk assessment. But regulators too often encourage this behaviour by making general assumptions about the value of different types of evidence in group audits. Auditors note that the first question regulators often ask are about visits to group companies and other auditors. Visits to other auditors or the entities they audit can be wasted if the purpose of the visit is not clearly thought out, the visit is poorly managed, if it is too short, undertaken for the sake of appearances, and if those sent are poorly briefed or are insufficiently experienced to deal with unprepared or hostile hosts. But such visits *are* often performed in the belief that regulators are less likely to question such an approach, than they are a decision to review files, which is too often interpreted as a cost management exercise.

9. The PCAOB refers to academic evidence suggesting increased coordination and communication challenges in geographically distributed work. The apparent obviousness of this aside, we are deeply concerned that the PCAOB appears to believe that such conclusions support the avoidance of such situations. Concerns about the ability of non-US firms to apply US GAAP and GAAS may be well founded in some cases. However, simply sending US nationals abroad to perform the work instead creates as many if not more serious problems than it solves, particularly if, as seems at least possible in many cases, those sent cannot speak the local language, cannot read the files and have superficial understanding of local business, regulatory and cultural norms. The ability of such staff to assess risk adequately is questionable at best. The potential cost of this to US investors is substantial.

10. The main thrust of the section on multi-layered audits appears to deal with situations in which it is appropriate to bypass other auditors at the head of a layer, going directly to other auditors at a lower level. In a few cases this may be appropriate but we are dismayed by the lack of focus on how to use these mezzanine auditors to better effect. Auditors currently have little practical choice but to work with such auditors and the proposals will not change that.

11. The overall impression given reading the proposals is that that the PCAOB regards firm and network-wide quality controls as untrustworthy, and believes that lead auditors should trust no-

one unless they have no choice, and that they should seek to perform the work themselves wherever possible. This approach seem to ignore, a number of structural issues that standard-setting cannot address. We urge the PCAOB to take a more nuanced and intelligent approach to these difficult issues. Investments made by network firms to improve common standards should enable lead auditors to make some use of the overall systems of quality control within such networks.

US investor interests

12. For all of the reasons set out above, we fear that if the proposals are implemented without further consideration, they risk not improving US investor interests because they may hamper audit quality in the manner described above, and because they may have a chilling effect on competition between firms. The pressure to use one firm of auditors throughout the group, which if often far from ideal from an audit quality angle, seems likely to be increased, particularly where mandatory auditor rotation is now in place. While more work would undoubtedly be performed and cost incurred, we are genuinely struggling to see the benefits in terms of improved audit quality in several important respects;

    - we challenge the PCAOB to properly reconcile its assertion that it is achieving its objectives through a risk based approach. The risk-based supervisory approach appears to be circumscribed: the risk assessment, which is already performed on the financial statements, is curtailed in the proposals and cannot be extended to the risks associated with the use of other auditors' work, not least as a result of the emphasis on direct communication with lower tiers of other auditors and in particular, making the lead partner directly responsible for the supervision and review of the entire group audit;

    - the development and application of quality control standards, both within firms and across networks, driven to a great extent by audit regulators, has been critical in enhancing audit quality the last fifteen years. Lead auditor work on the quality control standards of other auditors is key to the approach to many if not most large group audits. We do not question the need for improvement in the application of those standards, but we are perplexed by these proposals because while they acknowledge the importance of quality controls, they appear to dismiss their value almost entirely by effectively, if not explicitly, encouraging auditors to bypass auditors who co-ordinate other auditors by requiring direct communicating with lower tier auditors;

    - some aspects of the proposals regarding documentation seem unrealistic. Many attempts have been made in the past to exclude oral communication from audit evidence. They have failed because the presumption that only what is recorded in writing can be admitted as evidence is simply unworkable. It is wholly unrealistic to expect audit files to stand alone, to survive a 'nuclear attack'. Audit quality policies and procedures implemented at the firm level cannot and should not be duplicated on every file, not only because it is clearly a waste, but because the need to do so takes up valuable time that could be better spent on substantive issues. Some contextual explanation will always be required and auditors should not be encouraged to treat audit files as if their primary purpose was to act as defence documents in litigation.

Group audits and the supervision of other auditors are important, and we appreciate the PCAOB's diligence

13. In the light of the observations above, we believe that it is right and proper for us to suggest an alternative approach to the important issues the PCAOB raises. While ICAEW is a long-time supporter of the convergence of global auditing standards, on this occasion we do not suggest that the PCAOB should take the same approach as the IAASB to these issues. However, IAASB will likely revise ISA 600 in the foreseeable future and we urge both standard-setters to seek common ground wherever possible. We do not suggest that the PCAOB should adopt the IAASB's 'bottom up' component model with regard to group audits but consideration should be given to the need for a truly risk-based approach. As well as dealing with detailed requirements

for supervision, the PCAOB should also deal with how auditors scope group audits, how resources are deployed to execute the audit and the strategy that should be put in place to supervise such work. This standard on the supervision of other auditors can reflect a proper risk assessment to accommodate the many and varied approaches possible to group audits.

14. The standard should as a minimum:

- require lead auditors to set out the specific risks involved in a group audit engagement;
- set out factors for lead auditors to consider in performing the risk assessment;
- set out considerations regarding how lead auditors go about performing the assessment;
- require lead auditors to document their strategic approach to group audits.

15. Such an approach should reflect what firms currently aim to do. It does not represent the status quo in terms of auditing standards, because as the PCAOB acknowledges, most larger firms do more than what is currently required by the PCAOB, and by ISA 600, as evidenced by the IAASB's ITC *Enhancing Audit Quality*, and the responses thereto.

16. Group audits and the supervision of other auditors are far from straightforward issues, but they are important and we appreciate the time and effort standard-setters, including the PCAOB, are devoting to this area.

RESPONSES TO SPECIFIC QUESTIONS

We have not answered specific questions on issues that arise from PCAOB inspections and/or are specific to the US where our members have less exposure to such matters.

A: Discussion of proposed amendments, economic analysis, emerging growth companies and broker dealers – pages 1-54, questions 1-15

Q1: Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of other auditors that the Board should address? Are there additional concerns that the Board should seek to address?

17. Thirty years ago, when the complex group structures prevalent today were relatively rare, lead auditors could divide up parcels of the audit to different countries or offices, issue instructions in terms of what needed to be done for consolidation purposes, and gather information centrally. The quality controls exercised by other auditors were a peripheral issue in the majority of cases. Only a few of the very largest audits entailed some consideration of multi-layered audits.

18. Today, a high proportion of large multi-national group structures are complex and the multi-layered approach to control adopted by group companies is necessarily reflected in the way auditors approach them. Multi-layered audits are now the norm and barriers to access are more common. Group audits are now necessarily iterative, and more reliant on auditor quality controls. Auditors have of necessity developed a range of approaches to marry the resources required with those available to the best effect in any given situation. Auditors may decide to use the work of other auditors, or to send their own people in, use questionnaires, review files in their entirety or selected sections thereof, either on site or remotely, use translators in meetings with other auditors, and have schedules or reports translated. They may focus on the quality control policies and procedures in place when considering which approach to take, or they may ignore the work performed by other auditors altogether. What they do not and cannot do is to make general assumptions: it is not always better for lead auditors to perform the work than other auditors, it is not always better to visit than to review files remotely, and it is not

always better to review files than it is to use questionnaires. Auditors, as the PCAOB acknowledges, have learned from their experiences and responded.

Q2: Are these proposed amendments to existing standards appropriate? Are additional changes needed to increase the likelihood that the lead auditor is sufficiently involved in the other auditor's work? Should the Board require specific procedures to address business, language, cultural, and other differences between lead auditors and other auditors, and if so, what types of procedures?

19. The proposals state that the three areas of potential improvement in the current standards involve taking account of changes in auditing practice, applying a risk-based supervisory approach, and providing additional direction. We see the additional direction, but the proposals do not appear to acknowledge changes to auditing practice as they relate to the conduct of complex, multi-national group audits. The risk-based supervisory approach appears to be circumscribed: the risk assessment is performed on the financial statements (which in practice represents no change) but cannot be extended to the risks associated with the use of other auditors' work.

20. Furthermore, the PCAOB's own summary of the proposed amendments are entirely prescriptive in nature. They:

- *prescribe* procedures to be performed by the lead auditor with respect to the supervision of the other auditor's work;
- *require* that documentation includes a specified list of other auditors' working papers reviewed but not retained;
- *require* the engagement quality reviewer to evaluate the engagement partner's determination of his or her firm's sufficiency of participation in the audit.

21. The second requirement in particular is highly prescriptive. It will undoubtedly change behaviour, provide a regulatory objective and facilitate review without reference to auditors, but we struggle to understand the current mischief it is intended to address, still less how it will improve audit quality. Understanding what has been done would be better achieved through a review of files involving a discussion with the lead auditor, particularly when the files are in a foreign language. Reviewing any files in isolation is as bad for regulators as it is for lead auditors.

22. The third requirement is not risk-based. There will be many situations in which evaluating the engagement partner's determination of the firm's sufficiency of participation is a formality. A risk-based approach would require a review only in borderline cases.

23. We agree that changes are needed to increase the likelihood that the lead auditor is sufficiently involved in the other auditor's work, but we believe that the PCAOB has gone too far in some respects and that some of the proposals may have the unintended consequence of reducing the quality controls applied. The purpose of quality control policies and procedures is to enable the use of output with reduced testing thereof. If no reduction is permitted, the purpose of the controls is called into question and the PCAOB appears to be trying to have it both ways, by requiring auditors apply quality controls in a group situation, while denying them the benefit by ignoring the output in the form of audit reports produced by other auditors. This is particularly difficult to understand given that the PCAOB specifically acknowledges that the quality controls some firms now apply go beyond the requirements of standards, particularly with regard to:

- evaluating specific information about the education and experience of other auditors;
- continually updating the understanding of the other auditors' qualifications throughout the audit and making any necessary adjustments to the extent of supervision;
- communications between the lead auditor's senior engagement team members and other auditors about important matters that could affect the procedures they perform.

24. While we believe it is important for auditors and auditing standards to *acknowledge and respond to* the significant business, language, cultural, and other differences between lead auditors and other auditors, we believe that it would be difficult to enforce specific requirements to address them. Requirements that cannot be enforced, or that require significant interpretation, risk bringing the requirement into disrepute.

Q3: Are there any other areas of improvement in existing standards relating to audits that involve other auditors that the Board should address? Should the Board's standards be amended to address other responsibilities of the lead auditor? Are there related areas of practice for which additional or more specific requirements are needed, such as determining tolerable misstatement for the individual locations or business units under AS 2105?

25. Further guidance, not necessarily within a PCAOB standard, could usefully cover the *scoping of group audits* and the *application of materiality*. Both of these issues are fundamental in determining which other auditors to engage with and where audit effort needs to be focussed to ensure that a risk-based approach is taken. One possible effect of coverage of these areas might be *reduced* involvement of other auditors in group audit situations.

26. In particular, further guidance would be helpful in the following areas:

- how to determine materiality and performance materiality at component level, especially where there is a large number of insignificant components as this is an area that auditor's struggle with in practice;
- what constitutes sufficient appropriate evidence in groups where there are only non-significant components or the non-significant components represent a large proportion of the group;
- the evidential approach to shared service centres;
- qualitative considerations regarding the sufficiency of participation in the group audit.

Q4: The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

Q5: The Board requests comment generally on the analysis of the need for the proposal. The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

Q6: The Board requests comment generally on the potential benefits to investors and the public. Are there additional benefits the Board should consider?

Q7: The Board requests comment generally on the potential costs to auditors and companies they audit. Are there additional costs the Board should consider?

27. We believe costs and efforts formerly dealt with at a regional level in multi-layered audits may be pushed upwards in the chain if the requirement for the lead auditor to communicate directly with other auditors is adopted. Less detailed work will be performed by other auditors, more by lead auditors, which also leaves lead auditors less time to deal with the bigger picture. Multi-layered audit approaches are often adopted to facilitate client communication and to avoid the obvious issue of the lead auditor having an excessive number of other auditors reporting to them. We also anticipate difficulties in justifying the changes, regardless of cost or where they lie, to the audited entity. The proposed changes will set group structures and group audits out of kilter and may act as a barrier to effective communication between regional management and lead auditors.

28. The PCAOB notes that auditors incurring higher costs to implement the proposed requirements may pass at least part of those costs on to the client, implying that the PCAOB believes that firms are likely to have to absorb some costs themselves. The PCAOB is fully aware that this has a potential impact on audit quality, but it does not mention this. In any case, we do not believe that the PCAOB should pass comment on how additional costs should or are likely to be apportioned.

29. The PCAOB should address more fully the potential cost and other impacts of additional hiring requirements on smaller firms.

30. We note in our major points above the risks associated with having staff competent in US GAAP and GAAS but unfamiliar with local norms perform audit work, rather than working with other auditors, and the potential costs.

31. We urge the PCAOB to consider commissioning research on the impact of its work on choice in the audit market, which we believe is diminishing and likely to be further diminished, at least in part as a result of its enhanced requirements. The effects and costs are potentially substantial, long term and they are borne by US investors.

Q8: The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release adequate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?

32. We note in our answer to questions 4 to 7 above the potential impact of the PCAOB's proposals on the cost to US investors of:

- the use of US staff unfamiliar with local norms and requirements in the place of local staff;
- reduced competition in the audit market.

33. We note in our answer to 2 above, and question 9 below, the potential for the proposals to reduce the quality controls applied by lead auditors in group audit situations.

Q9: Could the proposed requirement for lead auditor supervision diminish (or be perceived as diminishing) the other auditor's accountability for the work the other auditor performs? If so, are any changes to the proposal needed to describe the other auditor's responsibilities?

34. We note in our answer to questions 2 and 8 above the potential for the proposals to have the unintended consequence of reducing the quality controls applied by lead auditors in group audit situations. The purpose of quality control policies and procedures is to enable the use of output with reduced testing thereof. If no reduction is permitted, the purpose of the controls is called into question. Furthermore, as the PCAOB itself points out, if the work of other auditors is displaced and marginalised by work performed by lead auditors, it seems at least possible that other auditors will be less diligent in executing work performed specifically for group audit purposes.

Q10: Could the proposed requirement for lead auditor supervision induce lead auditors in some audits to divide responsibility with another accounting firm rather than supervise the accounting firm? If so, how often might this division of responsibility occur?

We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q11: The Board requests comment generally on the alternative approaches that the Board considered but is not proposing, as described in this release. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?

35. We note that the Board considered the effectiveness of providing guidance or increasing inspection or enforcement effort to address concerns with the supervision of other auditors but concluded that interpretive guidance, inspections, or enforcement actions alone would be less effective in achieving the Board's objectives than in combination with amending auditing standards. We strongly support this holistic approach to changing behaviour, and we urge the PCAOB to consider innovative and co-operative approaches to inspection and enforcement as we believe there is scope for change in these areas to effect improved auditor behaviour.

36. We agree with the Board’s decision not to propose:

- a requirement based on quantitative thresholds;
- additional criteria for determining sufficiency of participation based on the location of the company's principal assets, operations, and corporate offices;
- requiring lead auditors to gain an understanding of the qualifications of all engagement team members outside the lead auditor's firm.

Q12: Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

37. We note in our main points above our belief that costs formerly dealt with at a regional level may be pushed upwards, and that we anticipate difficulties in justifying the changes generally to the audited entity. They will result in a misalignment between group structures and group audits which is unlikely to be welcomed by senior management, even if having US nationals perform more of the audit seems superficially attractive.

Q13: The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q14: The Board requests comment generally on the analysis of the impacts of the proposal on audits of brokers and dealers. Are there reasons why the proposal should not apply to audits of brokers and dealers? Are there any factors specifically related to audits of brokers and dealers that should affect the application of the proposal to those audits?

We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q15: How much time following SEC approval would accounting firms need to implement the proposed requirements?

38. We believe that the proposed requirements would require as a minimum 18 months to implement. In addition to training and the update of methodologies generally, group reporting instructions would need to be amended and the first year under the new regime would require additional planning and scoping, and re-negotiation of the terms of engagement in some cases.

B. Appendix 4 – Further Discussion and Remaining Questions

II. Terminology – Proposed Definitions

Q16: Are the proposed definitions of: (a) ‘engagement team,’ (b) ‘lead auditor,’ (c) ‘other auditor,’ and (d) ‘referred-to auditor’ appropriate? Do the proposed definitions clearly describe individuals and entities that are included in these definitions? Is it clear which

individuals or entities are not included in these definitions? If not, what changes to the proposed definitions are necessary?

39. We encourage the PCAOB to consider whether further alignment between its definitions and those of the IAASB are possible. 'Other' auditors are defined as including members of the engagement team who are not employees of the lead auditor and we note in our major points above and in our answer to question 17 below, that we believe that seconded staff should not be treated in this way. The critical issue should be who is supervising their work, not who is paying their salaries.

40. We find the definition of 'other' auditors generally confusing. On one reading, the only difference between 'other' auditors and 'referred to' auditors appears to be divided responsibility, but the definitions are substantially different. We are also unclear as to why firm shareholders are included in the definitions. Any possible simplification of these definitions would be helpful.

Q17: Some global network firms use short-term (several months) personnel sharing arrangements, during which some available personnel are seconded to other firms and function as their employees. Some firms contract with consulting firms or temporary workforce agencies for personnel that work alongside and in the same capacity as personnel on the engagement team that are employed by the lead auditor. Should these personnel be treated as part of the lead auditor?

41. The definition of other auditors encompasses individuals seconded to other offices within a firm or network. Treating London staff seconded to New York to work on a major UK audit with a NYSE listing as other auditors, as the proposals do, makes no sense. Modes of employment are more fluid than they were a generation ago and secondments are common. The legal employment status of such individuals is far less important than who is directing and supervising their work.

42. Seconded staff should be treated according to how they are supervised, not according to who pays their salaries.

Q18: Are there any situations in practice where applying the new definitions of 'engagement team' and 'other auditor,' including related requirements, would present practical challenges?

43. We note in our major points above and in our answer to questions 16 and 17 above our belief that staff seconded within firms and network firms should be treated according to whom is responsible for supervision of their work and not their legal employment status.

Q19: Should there be requirements for the lead auditor to: (1) specifically identify the engagement team members responsible for assisting the engagement partner of the lead auditor in fulfilling his or her supervisory responsibilities and (2) document such assignments? Should the individuals who assist the engagement partner with supervision be limited to engagement team members from the office issuing the auditor's report?

44. We believe that a requirement for lead auditor to specifically identify the engagement team members responsible for assisting the engagement partner of the lead auditor is unnecessary, and that the suggestion that is it needed is predicated either on an unjustified level of mistrust, or in the belief that the primary purpose of the audit file is preparation for inspection.

45. Supervision should not be limited to those in the office issuing the auditor's report because it is unlikely that that office will have a monopoly on competence and quality control. We note in our major points above our sense that the proposals are underpinned by a belief that lead auditors should trust no-one unless they have no choice, and that they should seek to perform the work themselves wherever possible. This approach is simply unworkable in modern audits.

Q20: To emphasize the importance of assigning the proposed planning and supervision requirements to personnel with the appropriate qualifications in audits involving other auditors, the proposed definition of 'lead auditor' references existing standards that describe making appropriate assignments of engagement responsibilities. Does this reference appropriately address the responsibility to seek planning and supervision assistance from qualified engagement team members in these situations?

46. References to existing standards that describe making appropriate assignments of engagement responsibilities are sufficient. There is no need for the PCAOB to explain further or repeat itself. Repetition, and saying the same thing again using slightly different words, is less likely to change auditor behaviour than robust inspection and enforcement of words that are already clear.

III. Proposed Amendments to AS 2101

Q21: The proposed requirements for determining whether a firm's participation is sufficient for it to serve as the lead auditor depend on the risks of material misstatement associated with the portion of the financial statements audited by the firm. (These requirements would apply regardless of whether the other auditor is from the same audit network as the lead auditor.) Should the Board consider alternative or additional criteria for determining whether a firm's participation is sufficient? For example, should the Board impose a quantitative threshold or specify criteria covering the locations of the company's principal assets, principal operations, or corporate offices? How would such criteria help address specific issues in practice?

47. We believe that some of the criteria the PCAOB is proposing for determining whether the firm's participation is sufficient are unworkable and for these reasons we believe that the PCAOB has no alternative but to require auditors to use their judgement regarding sufficiency of participation.

48. The PCAOB lists examples of information from the other auditor that may be relevant to the lead auditor's understanding of the other auditors' knowledge of the SEC and PCAOB independence and ethics requirements, and their experience in applying the requirements.

49. We do not question the need for lead auditors to understand the other auditors' knowledge of the SEC and PCAOB independence and ethics requirements; however, we do question what are effectively requirements as to how to go about it. The examples given are all of whole firm procedures and are not engagement specific. Even if other auditors can be persuaded to provide the information, it is not clear how lead auditors are going to substantiate it.

50. The PCAOB should recognise that sufficiency of participation cannot be looked at in isolation, and that the manner in which lead auditors interact with other auditors is critical. A key inspection finding of many audit regulators not only in the context of group audits, is that a standard approach is taken, regardless of the risk assessment. Examples should be provided not only of situations in which participation is sufficient, but of how the audit approach changes in situations in which participation is sufficient, at the lower end of the range, by comparison with the approach taken in which participation is at the higher end of the scale of sufficiency. A list of factors to *consider*, which would include local licensing requirements, would also be helpful.

51. The PCAOB's proposals focus on the audit of a large proportion of the relevant risks, but local licensing and statutory requirements focus on the consolidated financial statements. The two are often mutually exclusive because of group structures, and the proposals as they stand would mean that either no-one could serve as group auditor, or two auditors would need to be appointed in some cases, one for statutory purposes and one for PCAOB purposes.

52. The proposals would increase the number of situations in which the lead auditor for PCAOB purposes would be different to the statutory auditor. This is unsatisfactory, for reasons which

we would hope were obvious, but it is sometimes unavoidable. BP, for example, has a significant US operation but the UK listing means that the group auditor must be a UK firm. Many large businesses are registered in small countries. But these situations, in which two firms effectively sign off on the entire group should not be effectively mandated through excessive prescription of participation criteria by the PCAOB.

53. We note in our answer to question 11 above our agreement with the PCAOB's decision not to specify additional criteria for determining sufficiency of participation based on the location of the company's principal assets, operations, and corporate offices. Such criteria display a shallow understanding of risk assessment.

Q22: What are the practical challenges with applying the proposed engagement partner's determination of the firm's sufficiency of participation in the audit? What changes, if any, should be made to address those challenges?

54. In addition to the issues we raise in our answer to question 21, above, applying standards in borderline situations is likely to be challenging and we believe that the PCAOB should consider developing examples of such situations with suggestions as to how they might be resolved.

Q23: Are there situations in practice in which the proposed sufficiency determination would cause changes in the firm serving as lead auditor? If so, what are these situations? What are the potential effects of those changes, including potential effects on costs and audit quality? What changes to the proposal, if any, would mitigate these issues?

55. We note in our answer to question 21 above that if the PCAOB effectively mandates a US firm as lead auditor as a result of its proposed participation criteria, the lead auditor may not change, but there will effectively be two group auditors in some cases.

Q24: The proposed sufficiency determination would apply for audits in which the lead auditor supervises the work of other auditors and audits in which the lead auditor divides responsibility for the audit with another firm. Should there be different requirements for the divided-responsibility scenario, for example, should there be additional criteria that require increased lead auditor participation in a divided responsibility scenario? If so, what should those requirements be?

We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

Q25: Are the proposed requirements for the lead auditor to hold discussions with and obtain information from other auditors and referred-to auditors to identify and assess the risks of material misstatement appropriate and clear? Are there any practical challenges with this requirement? If so, what are they, and how could the proposed requirements be revised to address the challenges?

Q26: Are the additional proposed requirements for the lead auditor when planning an audit that involves other auditors, which address independence and ethics; registration; and qualifications of and communications with other auditors, appropriate and clear? Are there requirements that should be added to or removed from Appendix B of AS 2101? If so, what are those requirements and why should they be included or excluded?

56. Although Appendix B refers to 'discussions' with other auditors, the tone suggests that one-way written communications are the norm. Appendix 4, paragraph .B2a in particular, states that lead auditors obtain information and does not provide for two-way communication and for other auditors to pass information regarding risk up the chain.

Q27: The proposed amendments require the lead auditor to gain an understanding of each other auditor's knowledge of the SEC and PCAOB independence and ethics requirements and their experience in applying the requirements. Are there any additional costs or practical challenges associated with this? If so, what are they, and how could the proposed requirements be revised to mitigate these issues?

Q28: Should the requirement for the lead auditor to gain an understanding of the knowledge, skill, and ability of the other auditors be limited to engagement team members who assist the lead auditor with planning and supervision?

57. The requirement for lead auditors to gain an understanding of the knowledge, skill, and ability of the other auditors should not be limited to engagement team members who assist the lead auditor with planning and supervision. However, the requirements regarding how the understanding is obtained should be less specific.

Q29: Are the proposed requirements to determine that the lead auditor is able to communicate with the other auditors and gain access to their work papers appropriate and clear? If not, what changes to the proposed requirements are necessary?

58. The requirements are clear but not particularly helpful. Examples might help.

Q30: Are the proposed amendments to the requirements for determining the locations and business units at which audit procedures should be performed clear and appropriate?

59. The proposals appear to relate to access issues rather than the focus of audit effort. More evidence is not necessarily better evidence and a laundry list of working papers reviewed will not help assess the quality of the risk assessment or conclusions.

IV. Proposed Amendments to AS 1201

Q31: Are the proposed procedures to be performed by the lead auditor with respect to the supervision of the other auditor's work appropriate and clear? If not, how should the proposed requirements be revised?

60. The proposed procedures to be performed by the lead auditor with respect to the supervision of the other auditor's work are clear but we question the value of the specific documentation and communications in writing to audit quality. We note in our major points above our belief that while some of the proposed requirements will aid inspection, they will do little to improve audit quality. They may, as we have noted in numerous responses to the PCAOB in the past, divert attention from more important issues.

Q32: Currently, AS 1205.12 describes certain procedures that the lead auditor should consider performing when using the work of the other auditor (e.g., visiting the other auditor), which are not included in the proposal. Should the lead auditor be required to perform these or any other procedures? If so, what additional procedures should be required?

61. We note in our major points above the potentially adverse effects of regulatory pressure to visit other auditors. We strongly urge the PCAOB to avoid further prescription in this area.

Q33: Are the requirements for the written report from the other auditor sufficiently clear? Are these requirements appropriately scalable to the nature and significance of the work referred to the other auditor? Would the proposed requirement for the lead auditor to obtain a written report from the other auditor result in a significant change in practice? If so, what is the estimated economic impact (e.g., costs and benefits) of this change?

62. The requirements are clear and while writing things down may focus the mind, it does not, of itself, guarantee any improve audit quality. Quality discussions and reviews of working papers may be a more effective mechanism of improving audit quality and documentation needs to be tailored to the lead auditors assessment of the quality of work performed by other auditors.

Q34: Is the scalability of the proposed supervision amendments clear and appropriate? If not, what changes are necessary? Are the proposed requirements for situations in which the lead auditor directs an other auditor to perform supervisory procedures with respect to a second other auditor on behalf of the lead auditor clear? If not, how should the proposed requirements be revised?

63. The scalability of the proposed supervision amendments is not at all clear. The statement to the effect that lead auditors are not required to review all of the other auditor's work papers to determine whether the other auditor performed its work as requested is helpful, as are the associated suggestions regarding risk and discussions, but they are very high level.

Q35: In a multi-tiered audit where the lead auditor directs the first other auditor to perform certain procedures with respect to the second other auditor, is the proposed requirement that lead auditor inform directly all other auditors of certain other specific matters appropriate? If not, how should the proposed requirements be revised?

64. We believe that the proposed requirements for lead auditors to inform directly all other auditors of certain other specific matters in addition to informing the first auditor is wholly inappropriate and displays (and indeed could be construed as encouraging) a wholly unnecessary level of distrust. We believe that the requirement should be removed.

Q36: In a multi-tiered audit, is the proposed requirement for the lead auditor to evaluate the first other auditor's supervision of the second other auditor's work clear? If not, how should the proposed requirements be revised?

Q37: Do the proposed requirements sufficiently cover the types of multi-tiered structures used today? If not, what other multi-tiered structures are used and what changes are needed to appropriately cover those situations?

Q38: Do issues exist when the lead auditor directs an other auditor to perform supervisory procedures with respect to a second other auditor on behalf of the lead auditor that should be addressed in AS 2101, for example, with respect to the qualifications of other auditors? What are the issues and what proposed requirements should be added to appendix B of AS 2101?

65. We note in our major points above our belief that the requirements do not sufficiently cover the types of multi-tiered structures used today.

Q39: Should certain of the proposed supervision procedures be required to be performed by individuals at the office issuing the auditor's report versus the firm issuing the auditor's report? If so, which procedures? Why should such required procedures be confined to individuals located at a particular office of the firm issuing the auditor's report?

66. We do not believe that it is necessary for any proposed supervision procedures to be required to be performed by individuals at the office issuing the auditor's report versus the firm issuing the auditor's report.

Q40: Do the proposed requirements provide sufficient emphasis on the need for two-way communication between the lead auditor and the other auditor throughout the audit? If not, what changes to the requirements are necessary to further promote such communication?

67. We note in our answer to question 26 above a specific example of proposed requirements that do not emphasis sufficiently the need for two-way communication between the lead auditor and the other auditor. We also note that extant ISA 600 probably needs to be updated in this respect.

A. Proposed Amendments to AS 1215 Related to Documentation of the Review of Documents Not Retained by the Office Issuing the Auditor's Report

V. Proposed Amendments to AS 1215

Q41: The proposed requirement in AS 1215.19A is designed to provide additional information about the review of working papers performed by the lead auditor. Is the proposed requirement appropriate and clear? Why or why not? What other information about the review of the working papers performed by the lead auditor would be appropriate?

68. Additional information about working papers reviewed but not obtained is an administrative issue and we struggle to understand how it will improve audit quality, as it will give no indication regarding substantive content, or the quality thereof.

Q42: The proposal does not require that the lead auditor make a list of all documents in the other auditor's files, including those not reviewed by the lead auditor. Should the lead auditor be required to document work papers in the other auditor's files that the lead auditor has not reviewed? Would such a requirement improve audit quality? What potential costs or unintended consequences, if any, would be associated with such a requirement? What practical difficulties would there be in complying with such a requirement?

69. The lead auditor should not be required to document work papers in the other auditor's files that the lead auditor has not reviewed.

Q43: In addition to the information currently in AS 1215.19, should the office issuing the auditor's report be required to obtain, review, and retain other important information supporting the other auditor's work, eg, (1) information about related parties or relationships or transactions with related parties previously undisclosed to the auditor or determined to be a significant risk; or (2) information about significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature?

70. Requiring the retention of information relating to specific accounting areas is a dangerous precedent to set. Furthermore, while retaining information may always, in theory, aid the inspection process, we struggle to understand how retention will of itself, will improve audit quality. Auditor judgements regarding the significance of that information are more important.

Q44: In addition to the information currently in AS 1215.19g about all significant deficiencies and material weaknesses in internal control over financial reporting, should the office issuing the auditor's report be required to obtain, review, and retain information about all control deficiencies identified by other offices of the firm and other auditors?

71. While retaining information may aid the inspection process, we struggle to understand how, in isolation, retaining information about all control deficiencies identified by other offices of the firm and other auditors, will improve audit quality. Deficiencies identified by the other auditor may be completely inconsequential to the lead auditor and requiring such information to be communicated unnecessarily burdens the lead auditor. Auditor judgements regarding the significance of that information are more important

VI. Proposed Amendment to AS 1220

Q45: Should there be a requirement (as proposed) for the engagement quality reviewer to focus the reviewer's attention on the engagement partner's determination of the firm's sufficiency of participation in the audit?

72. The engagement quality control reviewer should not be required to re-perform the engagement partners' work in any specific respect. To require an evaluation of the engagement partner's determination of the sufficiency of participation is to set a dangerous precedent, as it is just one of many potential issues that the reviewer may wish to evaluate depending on the circumstances of the audit. In many cases, the extent of participation would be such that any such evaluation would be wasteful formality.

Q46: Are there any additional engagement quality review procedures that should be required for audits that involve 'other auditors' or 'referred-to auditors' (as proposed to be defined)?

73. There are no additional engagement quality review procedures that should be required for audits that involve other or referred-to auditors.

VII. Proposed New Standard for Audits that Involve Referred-to Auditors

We have not responded to the following questions as they arise from PCAOB inspections and/or are specific to the US.

Q47: Are the objectives of the proposed new standard clear and appropriate? If not, what changes are necessary?

Q48: Are the proposed requirements for performing procedures with respect to the audit of the referred-to auditor clear and appropriate? If not, what changes are necessary?

Q49: Are the conditions included in paragraph. 06 of the proposed new standard clear and appropriate? Are there other conditions that should be met for the lead auditor to divide responsibility with a referred-to auditor?

Q50: Paragraph .07 of the proposed new standard describes the lead auditor's course of action in situations in which the lead auditor cannot divide responsibility. Are the requirements in this paragraph clear and appropriate? Why or why not? Are additional requirements necessary for such situations?

Q51: An unintended consequence of the Board's proposal, described earlier in this release, is the potential increase in the use of the divided responsibility model by auditors. Should the Board prohibit divided responsibility arrangements or impose further limitations on them, such as limiting them to equity method investees or situations in which the referred-to auditor covers only a small portion of the consolidated assets or operations? If so, what would be the costs and benefits of such a prohibition or limitation?

Q52: Are additional requirements, including supervisory requirements, necessary to describe responsibilities of the lead auditor in situations in which the lead auditor divides responsibility for the audit with another accounting firm? Are there any other situations that would present challenges with the application of the proposed requirements?

VIII. Other Considerations

A. Proposal to Supersede AI 10 (currently AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*), *Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205*

Q53: Is superseding AI 10 appropriate, or is the interpretation necessary to fully describe the auditor's responsibilities under PCAOB standards?

We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

B. Proposed Amendments Relating to Inquiries About Professional Reputation and Standing

Q54: Are the other proposed amendments relating to inquiries about professional reputation and standing of other auditors appropriate and clear in the context of each requirement? If not, what further amendments should the Board consider making to this requirement to improve its clarity?

We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

IX. Additional Questions Regarding Certain Aspects of the Proposal

We have not responded to the following questions as they arise from PCAOB inspections and/or are specific to the US.

Q55: Are the proposed conforming amendments in Appendix 3 appropriate and clear? Why or why not? What changes to the amendments are necessary?

Q56: In addition to the proposed conforming amendments in Appendix 3, are other conforming amendments necessary in connection with the proposed changes to AS 1201, AS 1215, AS 1220, and AS 2101?

Q57: Paragraph .10d of AS 1301 (currently Auditing Standard No. 16), Communications with Audit Committees, describes requirements regarding the lead auditor's communication to the audit committee of certain information about the other auditors. Should the lead auditor's communication to the audit committee with respect to the lead auditor's or other auditors' responsibilities in an audit be more specific than is currently required? If so, what additional information should the lead auditor communicate?

Q58: Because the Board's proposal focuses on audit engagements, it does not include amendments for engagements other than audits. Should the proposal include changes for reviews of interim financial information under AS 4105, Reviews of Interim Financial Information (currently AU sec. 722, Interim Financial Information) that involve 'other auditors' or 'referred-to auditors' (as proposed to be defined)? If so, what additional changes are needed?

Q59: Is it sufficiently clear when AS 1201 (as proposed to be amended) or proposed AS 1206 – as opposed to AS 2503 – would apply to an audit of a company's equity method investment or other investments in an entity whose financial statements are audited by another accounting firm? If not, what change or guidance is needed?